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S. HRG. 99-432

CHILD HEALTH INCENTIVES REFORM PLAN; AND LEGISLATION RELATED TO FARM CO-OPS

UNIVERSITY OF

HEARING

BEFORE THE

SUBCOMMITTEE ON
TAXATION AND DEBT MANAGEMENT

OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-NINTH CONGRESS

FIRST SESSION

JULY 15, 1985

Printed for the use of the Committee on Finance

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WASHINGTON 1986

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CHILD HEALTH INCENTIVES REFORM PLAN; AND LEGISLATION RELATED TO FARM CO-OPS

MONDAY, JULY 15, 1985

U.S. SENATE,
COMMITTEE ON FINANCE,
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT,
Washington, DC.

The committee met, pursuant to notice, at 9:30 a.m., in room SD-215, Dirksen Senate Office Building, Hon. John H. Chafee (chairman) presiding.

Present: Senator Chafee.

[The press release announcing the hearing, a report prepared by the Joint Committee on Taxation, and opening statements of Senators Chafee and Heflin, follow:]

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Press Release No. 85-052

PRESS RELEASE

For Immediate Release
Wednesday, July 3, 1985

Contact: Sam Richardson
(202) 224-4515

JULY 15 COMMITTEE ON FINANCE HEARING TO REVIEW TWO PROPOSALS

Proposals on child health and farm co-operatives will be reviewed by the Senate Committee on Finance's Subcommittee on Taxation and Debt Management at a July 15, 1985, hearing, Committee Chairman Bob Packwood (R-Oregon) announced today.

The hearing is scheduled to begin at 9:30 a.m., Monday, July 15, 1985, in Room SD-215 of the Dirksen Senate Office Building in Washington.

Senator John H. Chafee (R-Rhode Island), Chairman of the Taxation and Debt Management Subcommittee, will preside at the hearing.

The two proposals to be examined:

* S. 376, the Child Health Incentives Reform Plan, sponsored by Senator Chafee, which would amend the Internal Revenue Code of 1954 to deny an employer a deduction for group health plan expenses unless such plan includes coverage for pediatric preventive health care.

* A proposal by Senator Mack Mattingly (R-Georgia) to allow the netting of income and losses of different administrative units within a single farm co-operative.

"I'm happy we're able to provide this opportunity for these proposals to receive a public hearing before our Committee," Chairman Packwood said. "I'm sure the testimony received will provide us with a solid base of information on which to proceed."

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DESCRIPTION OF PROPOSAL RELATING TO COMPUTATION OF NET INCOME FOR COOPERATIVES

Scheduled for a Hearing

Before the

SUBCOMMITTEE ON TAXATION
AND DEBT MANAGEMENT

of the

COMMITTEE ON FINANCE

Prepared by the Staff

of the

JOINT COMMITTEE ON TAXATION

July 12, 1985

JCX-8-85

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INTRODUCTION

This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of a proposal by Senator Mattingly relating to the computation of net income for cooperatives. The proposal is scheduled for a public hearing on July 15, 1985, before the Senate Finance Subcommittee on Taxation and Debt Management.

The document provides a description of present law Code provisions relating to the Federal income tax treatment of cooperatives (including farmers' tax-exempt cooperatives) and of the proposal by Senator Mattingly.

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[1] This document may be cited as follows: Joint Committee on Taxation, Description of Proposal Relating to Computation of Net Income for Cooperatives (JCX-8-85), July 12, 1985.

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DESCRIPTION OF PROPOSAL RELATING TO COMPUTATION OF NET INCOME FOR COOPERATIVES -- SENATOR MATTINGLY

A. Present Law

In general

Cooperatives, including tax-exempt farmers' cooperatives, and their members are subject to special tax rules under subchapter T of the Code (sec. 1381 et seq.). In general, these provisions operate to treat the cooperative more like a conduit than a separate taxable business enterprise. The primary reason for doing so is to avoid penalizing (by imposing a corporate tax) a group of individuals or business organizations who collectivize their marketing or purchasing efforts in order to take advantage of economies of scale.

Definition of cooperatives

In general, the subchapter T rules apply to tax-exempt farmers' cooperatives described in section 521(b) or any other corporation operating on a cooperative basis (except mutual savings banks, insurance companies, other tax-exempt organizations, and certain utilities).

A tax-exempt farmers' cooperative is specifically defined in section 521(b) as a farmers', fruit growers', or like association organized and operated on a cooperative basis for the purpose of marketing the products of its members or others, or for the purpose of purchasing supplies and equipment for members and other persons. In the case of a tax-exempt farmers' cooperative that markets products, the proceeds of sale by the cooperative less expenses of sale are turned over to the members or other producers on the basis of the quantity or value of the products furnished; in the case of a tax-exempt farmers' cooperative that purchases supplies and equipment, the purchased goods are to be made available at the cooperative's cost plus actual expenses.

Income tax treatment of cooperatives

For Federal income tax purposes, a cooperative generally computes its income as if it were a taxable corporation, with one important exception--the cooperative may deduct from its taxable income patronage dividends paid. In general, patronage dividends are the profits of the cooperative that are rebated to its patrons pursuant to a preexisting obligation of the cooperative to do so. The rebate must be made in some equitable fashion on the basis of the quantity or value of business done with the cooperative. This rebate

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may be in a number of different forms.

In general, cooperatives are permitted to deduct patronage dividends only to the extent of net income derived from transactions with its members. However, a tax-exempt farmers' cooperative generally may deduct patronage dividends to the full extent of its net income and may also deduct, to a limited extent, dividends on common stock. The availability of these deductions for the cooperative has the effect of allowing the cooperative to be treated like a conduit--in the case of tax-exempt farmers' cooperatives, with respect to all profits, and in the case of other cooperatives, with respect to profits derived from transactions with members.

Members of cooperatives who receive patronage dividends must treat the dividends as income, reduction of basis, or some other treatment that is appropriately related to the type of transaction that gave rise to the dividend. For example, where the cooperative markets a product for one of its members, patronage dividends attributable to the marketing are treated like additional proceeds from the sale of the product and are includible in the recipient's income. Where the cooperative purchases equipment for its members, patronage dividends attributable to equipment purchases are treated as a reduction in the recipient's basis in the purchased equipment (provided the recipient still owns the equipment).

B. Description of the "Netting" Issue

Frequently, a cooperative's business consists of making purchases or marketing goods in several product lines, several geographic areas, or both. Some cooperatives both make purchases and market goods. A typical practice for a cooperative that has such diverse activities is to calculate its net income on a cooperative-wide basis, netting gains from profitable products or geographic areas with losses from unprofitable ones. The cooperative pays patronage dividends based on the net income so computed. Assuming that the entire net income is distributed and the entire amount of the dividends is otherwise deductible, the cooperative takes the position that it has no tax liability.

The Internal Revenue Service has taken the position that the rules for taxing cooperatives do not allow a cooperative to net gains and losses from different operations in any manner it chooses. The IRS justifies this interpretation by reference to the requirement that a cooperative must allocate its profits and losses equitably among its patrons for purposes of paying patronage dividends. The IRS maintains, for example, that especially if not agreed to in advance by all patrons, allocation of the losses of the marketing

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operations for product A against the gains from the marketing operations for product B (perhaps in a different region), may not be an equitable allocation, since it reduces the amount of patronage dividends that the patrons who supplied product B are entitled to. As a result, under this interpretation, the cooperative may not have fully distributed its profit attributable to the marketing of product B and is taxable on the undistributed amount of profit. Thus, under the IRS interpretation, unless netting were considered equitable under the circumstances, in order to eliminate its tax liability, the cooperative might have to pay dividends equal to the total profits of its profitable allocation units without reduction for the losses of its unprofitable allocation units.

The U.S. Tax Court decided in a 1980 case (Ford-Iroquois FS, 74 T.C. 1213 (1980)) that losses from a nonexempt cooperative's marketing operations could be carried forward to offset income from its supply operations, even where the losses that were carried forward were generated from transactions with patrons other than the patrons the gains from whose transactions were offset. The Tax Court has also held for the taxpayer in cases involving somewhat different circumstances where the IRS also argued that a cooperative had taxable income because it failed to make an equitable allocation among its patrons of its profits and losses (Lamesa Cooperative Gin, 78 T.C. 894 (1982) (a small amount of gains from a relatively insignificant supply operation could be offset against marketing operation losses); Associated Milk Producers, 68 T.C. 729 (1977) (losses from one year's operations could be carried forward to subsequent years)).

C. Explanation of Proposal

The proposal by Senator Mattingly relates to the provisions of subchapter T and the definition of tax-exempt farmers' cooperatives in section 521(b). The proposal would specify that in computing its net income, a cooperative may offset income from one or more of its allocation units (whether functional, divisional, departmental, geographic, or other) with losses from other allocation units. The proposal also would specify that a tax-exempt farmers' cooperative does not lose its exempt status merely because it offsets losses incurred in either its purchasing or marketing operations against earnings in either of such operations for purposes of computing its net earnings available for distribution to its patrons.

D. Other Congressional Action

The supplemental appropriations bill for fiscal year 1985, as reported by the Senate Committee on Appropriations

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(H.R. 2577; S. Rep. No. 99-82), included an amendment by Senator Mattingly to prohibit the IRS from disallowing cooperatives subject to section 521 or subchapter T of the Code from netting earnings and losses among any of their purchasing and allocation units.

This provision was replaced by a Senate floor sense-of-the-Senate amendment to H.R. 2577 (by Senators Packwood and Mattingly) to have the Treasury Department study the question of whether cooperatives subject to section 521 or subchapter T of the Code may net earnings and losses among any of their purchasing and marketing allocation units in determining the amount of patronage dividends to be issued and their taxable income after the deduction for patronage dividends (see 131 Cong. Rec. S 8554-56 (daily ed. June 20, 1985)).

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STATEMENT BY SENATOR JOHN H. CHAFEE TO THE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

Good morning. Before we begin, I wish to take a moment to welcome Senators Thurmond, Nunn, and Mattingly. I know they are genuinely concerned about this issue we are hearing about today and I look forward to hearing their views.

This morning we are to hold a hearing on Senator Mattingly's proposal to clarify the tax treatment of farm cooperatives, specifically, the area of "netting" of gains and losses between allocation units.

Farm cooperatives sell goods or make purchases on behalf of its members, collectively. Any profit is distributed to the members, in proportion to the amount of business each conducts with the co-op, in the form of patronage dividends.

The issue we are to look at today arises when the coop which conducts business in several different products or geographic areas wishes to "net" the losses experienced in one product or area against gains in another.

This has been a controversy now for almost 20 years. The Internal Revenue Service has taken the position that this "netting" between different units of the coop is inequitable because the patrons of one unit are not identical to the patrons of another. The cooperatives and also, I should note, the tax court strongly disagree, viewing nettings as a business judgment permitted by the tax code.

Several times this year Senator Mattingly has brought this matter to the attention of the Senate. I hope this hearing can lead the way to a resolution of this matter.

I look forward to hearing from my colleagues and the other witnesses who have come to discuss this question this morning.

STATEMENT OF SENATOR HOWELL HEFLIN BEFORE THE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

Mr. Chairman, I appreciate the opportunity to testify before the committee on behalf of the 6,000 farmer cooperatives across the nation. I join with my colleagues in urging the Finance Committee to seek a legislative remedy to the recurring problem that farmer cooperatives are having with the Internal Revenue Service.

The issue is simple, Mr. Chairman. Will we continue to allow cooperatives the right to offset gains and losses of various divisions within the cooperatives in determining the amount of the patronage refunds which will be paid, the tax deductibility of such refunds and the net taxable income of the cooperatives?

Over a period of nearly fifteen years there has been a recurring effort by the IRS to question this right of agricultural cooperatives to arrive at their taxable income by netting gains and losses among their patron units. The issue has been litigated on three different occasions, and in each instance the tax court ruled against the IRS. Yet in January of this year, the IRS issued a ruling holding that cooperatives may not net gains and losses.

Mr. Chairman, this legislation would simply reaffirm the findings of the courts, and allow agricultural cooperatives to function as they were designed, to allow members to share in the risk and rewards. The American farmer is having enough problems during this time of economic difficulty. Why should we further penalize the nearly two million farmer members of these cooperatives. Farmer cooperatives should not be required to continue spending their funds to litigate the IRS's memorandum regarding netting.

Mr. Chairman, I would urge the committee to report out legislation that would reaffirm and clarify the right of farmer cooperatives to net gains and losses within and among their allocation units.

Thank you, Mr. Chairman.

Senator CHAFEE. Is there somebody here representing Senator Mattingly?

[No response.]

Senator CHAFEE. All right. Let's start with the Treasury witness, then.

Mr. MENTZ. Sure.

Senator CHAFEE. Before we begin, I would like to say that we are going to hear testimony this morning on a proposal of Senator Mattingly's to clarify the tax treatment of farm cooperatives, especially the area of netting of gains and losses between allocation units.

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Farm cooperatives sell goods or make purchases on behalf of its members, collectively. Any profit is distributed to the members in proportion to the amount of business each conducts with the co-op, in the form of patronage dividends. The issue we are to look at today arises when the coop which conducts business in several different products or geographic areas wishes to net the losses experienced in one area or product against gains in another. Now, this has been a controversy for almost 20 years. The Internal Revenue Service has taken the position that this netting between different units of the co-op is inequitable because the patrons of one unit are not identical to the patrons of another. The cooperatives, and also I should note, the Tax Court strongly disagree, viewing netting as a business judgment permitted by the Tax Code. Several times this year, Senator Mattingly has brought this matter to the attention of the Senate. I hope this hearing can lead the way to a resolution of the matter. I look forward to hearing from my colleagues and the other witnesses who have come to discuss the question this morning. Now, I see Senator Nunn is here and Senator Mattingly is here. Why don't you just step aside, Roger, and we will start with the two Senators. Gentlemen, if you would be good enough to come right up? We welcome you here. Senator Thurmond will be along later, and he can join you at the table. As I mentioned earlier, this is a hearing on Senator Mattingly's proposal to clarify the tax treatment of farm cooperatives, especially the area of netting. So, we welcome the two distinguished Senators from Georgia. Senator Mattingly, since this is your proposal, why don't you go ahead?

STATEMENT OF HON. MACK MATTINGLY, U.S. SENATOR FROM THE STATE OF GEORGIA

Senator MATTINGLY. Thank you, Mr. Chairman. I first want to thank the subcommittee for arranging this hearing in such a prompt and cooperative manner.

Senator CHAFEE. And at such an early hour. [Laughter.]

Senator MATTINGLY. Yes. As you all recognize, the topic that we are discussing today is of great importance to the nearly 2 million members of our Nation's farmer-owned cooperatives. I might add that this issue is of some urgency to the co-ops, which are in imminent danger of being told by the IRS that they must go back into past years and pay taxes, penalties, and interest because they utilized the practice of netting their gains and losses among the several areas of cooperative business activity for the purpose of determining their taxable income. This practice of offsetting profits made in one area of business activity against losses incurred in another area of activity conducted by the same organization is not an exception to the rule. Indeed, it is a practice available to all types of business enterprises, whether sole proprietorships, partnerships, or corporations. The U.S. Tax Code has distinctly found that farmer-owned cooperatives are also eligible to employ the same practice of netting gains and losses among their several divisions for tax purposes. But, despite the clear and unambiguous language used by the Tax Court in overturning the IRS decisions against co-op netting, the farmer finds himself faced again with another attempt by the Service to change the law by administrative fiat.

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Now, Mr. Chairman, I respect that fact that both you and Chairman Packwood were somewhat concerned when I earlier attempted to introduce amendments to rectify this problem. I understand and even appreciate your completely proper actions taken to preserve the jurisdiction of this committee and the integrity of Senate procedure. However, I can only speculate about the kinds of thoughts which must pass through your minds when an executive branch agency, such as the IRS, blatantly attempts to completely circumvent not only this committee but the entire Congress. Their cavalier attitude has obviously raised the concern of at least 32 of our Senate colleagues who have either addressed their complaint to Secretary Baker or who signed as cosponsors of the amendment which I had earlier intended to introduce to the imputed interest bill. I would just note that, among the 32, seven were members of the Finance Committee. Mr. Chairman, I have copies of those two letters. I would ask that they be netered in the record as though fully read.

Senator CHAFEE. Yes.

[The copies of the two letters follow:]

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DEPARTMENT OF AGRICULTURE
OFFICE OF THE SECRETARY
WASHINGTON, D.C. 20250

APR 8 1985

The Honorable James A. Baker, III
Secretary of Treasury
Washington, D.C. 20220

Dear Jim:

The Internal Revenue Service recently issued a technical advice memorandum stating that a farmer cooperative may not offset losses in one of its divisions against the gains in another to determine its net taxable income if, in the IRS' opinion, the offset is "inequitable." This common practice, called "netting" could cause a farmer cooperative to lose its tax status if gains and losses are combined in its purchasing and marketing divisions to compute patronage dividends.

The IRS memorandum also says that when a cooperative's board of directors makes netting decisions, the cooperative will lose its statutory right to deduct patronage refunds from taxable income.

I would appreciate your review of the IRS technical advice memorandum for the following reasons:

1. Farmer cooperatives must have the authority to net gains and losses in their various divisions in order to survive in today's highly volatile agricultural industry. By netting gains and losses among several divisions, a cooperative may spread economic risk and significantly reduce the effect of catastrophic failure in any one of them.

2. IRS' determination imputes values and principles to the internal cost accounting methods of cooperatives that appear to be inappropriate under the laws governing cooperatives.

The Department of Agriculture previously expressed its concerns to the IRS and the Department of the Treasury on the issue of netting. Withdrawal of the IRS memorandum would aid efforts to reach accommodation between Department of Agriculture and Department of Treasury on this important tax issue.

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This matter is of vital concern to the nation's farmer cooperatives. I believe that your thorough view of this issue will show that the IRS position merits reconsideration. I appreciate your consideration in this matter.

Sincerely,

JOHN R. BLOCK
Secretary

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MARK MATTINGLY

United States Senate
WASHINGTON, DC 20510

April 22, 1985

Honorable James A. Baker, III
Secretary, Department of the Treasury
15th Street & Pennsylvania Ave., N.W.
Washington, D. C. 20220

Dear Mr. Secretary:

Over a period of nearly fifteen years there has been a recurring effort by the Internal Revenue Service to question the right of agricultural cooperatives to arrive at their taxable income by netting gains and losses among their patron units.

Secretaries of Agriculture over the years have submitted extensive and detailed analyses on behalf of the farmer-owned cooperatives but the issue remains unsettled. Recently Secretary Block wrote to you asking for your assistance and intervention regarding withdrawal of the recent IRS memorandum relating to this issue.

This is a vitally important matter to a great many of this Nation's farm cooperatives. The nearly two million farmer/members of these cooperatives are, as you know, having great economic difficulty.

We urge you, Mr. Secretary, to give this important matter your prompt and favorable attention.

Sincerely,

Jesse Helms

John P. East

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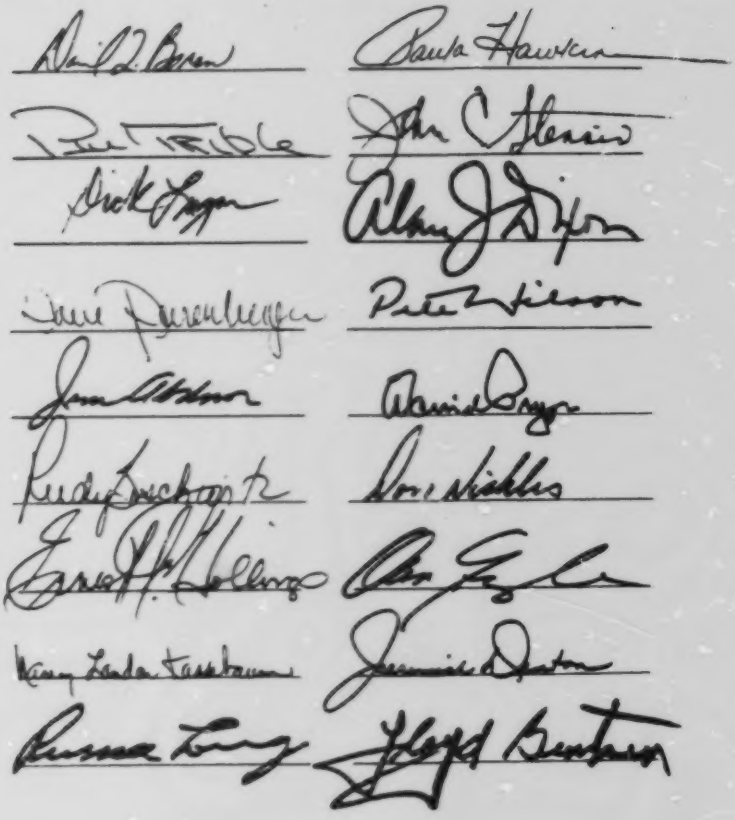
Secretary James A. Baker, III
April 22, 1985
Page two



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United States Senate
WASHINGTON, DC 20510

June 25, 1985

Dear Colleague:

For nearly twenty years the Internal Revenue Service has attempted to deny farmer-owned agricultural cooperatives the right to offset losses in one area of business activity against gains from other areas of activity. This practice--referred to as netting--is allowed routinely for all other proprietary business enterprises. However, in 1965, the IRS started to question the right of cooperatives to net gains and losses.

The issue has been litigated on three different occasions, and in each instance Tax Court rulings against the IRS clearly reaffirmed the right of agricultural cooperatives to net gains and losses among their various divisions. Never known to take "no" for an answer, the IRS again in January of this year issued a ruling holding that cooperatives may not net gains and losses.

Thus, we are now seeking your support for an amendment to H.R.2475, the imputed interest simplification bill. The amendment will merely spell out what the Tax Court has been trying to tell the IRS--that agricultural cooperatives shall be allowed to net gains and losses in determining taxable income.

We are enclosing an issue brief on the subject and a copy of the proposed amendment. If you would like to join us in co-sponsoring this measure please contact Cliff Humphrey at 4-3643.

Sincerely,

Jim Exon
Mark Mattingly
Jim Abdnor
Ted Stevens
Thad Cochran
Strom Thurmond

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Agricultural Cooperative Amendment
Dear Colleague, June 25, 1985
Page Two

Howell Heflin — Jesse Helms

David L. Boren — Don Nickles

Jeremiah Denton — John P. East

Bill Bradley — Alfonse D'Amato

John Warner — Henry Lee Lee Kennedy

Rudy Boschwitz — Patty Murray

Larry Pressler — Tom Harkin

Bill Armstrong — Dan Quayle

Pete Wilson — MR. SYMMS

MR. GRASSLEY

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Senator MATTINGLY. Now, Mr. Chairman, you were also aware of the concerns expressed by Secretary Block over the IRS actions. He, too, expressed his feelings on this issue in writing to both Secretary Baker and to this committee. I would ask that copies of his letters also be entered in the record as though read in their entirety.

Senator CHAFEE. Yes, that will be done.

[A letter of Secretary Block to Senator Packwood follows:]

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DEPARTMENT OF AGRICULTURE
OFFICE OF THE SECRETARY
WASHINGTON, D. C. 20250

JUN 2? 8?

Honorable Robert Packwood, Chairman
Committee on Finance
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

An amendment will probably be offered during full Senate consideration of H.R. 2475, the imputed interest tax bill, to amend sections 1388(a) and 521(b) of the Internal Revenue Code. The changes are intended to make it undisputably clear that cooperatives can net earnings and losses from different lines of business when computing their taxable income.

The U.S. Department of Agriculture supports enactment of this amendment.

Cooperatives are owned and controlled, on a democratic basis, by their members. The members may decide to have their cooperative only provide one service, such as marketing their grain. Financial results of this activity are figured on an annual basis and a tax is paid on any margins generated by the business.

The members may also decide to have their cooperative provide more than one service, such as marketing grain and purchasing supplies. When this happens the Internal Revenue Service has ruled the association must, for tax purposes, assume it is not a single cooperative but rather that separate cooperatives exist for each function performed.

The IRS position is contrary to a basic tenet of corporations operating on a cooperative basis: that the members decide the extent to which they share the risks in the cooperative venture. A decision by members to diversify risk by netting the results of two or more operations is a legitimate business decision which ought to be immune from challenge by IRS. Cooperatives are voluntary organizations. Members who do not like the way margins are computed are free to do business elsewhere, or start a competing cooperative which accounts for margins as its members prefer it done.

The U.S. Department of Agriculture favors enactment of legislative language making it clear that members of a cooperative may net margins and losses on any basis that they decide is equitable among themselves.

Sincerely,

John R Block

John R. Block
Secretary

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Senator MATTINGLY. Now, as I have indicated in my earlier statements on the issue, we are here today to simply seek fairness and equity for our farmer-owned cooperatives in the application of the Tax Code. We do not ask the statute be changed, only that language be added which makes perfectly clear to the Internal Revenue Service what the Tax Court has tried to tell them on three different occasions: that farm co-ops are entitled to use netting procedures in determining patronage dividends for tax purposes. One would think that such legislative action would be unnecessary, given the rather blunt language found in the court decisions. Unfortunately, the Service seems rather prone to selective deafness when anyone tells them something they don't want to hear. Mr. Chairman, I again thank you and your staff for accommodating us here at this early hour and request that the subcommittee act as expeditiously as possible in reporting language similar to that which was contained in my proposed amendment. I would ask that a copy of the amendment be included for the record as though read. And I encourage and urge your continued assistance in this effort to put an end to what the court referred to in one decision as "the IRS unwarranted tinkering with the tax structure applicable to cooperatives." Thank you, Mr. Chairman.

Senator CHAFEE. Thank you very much, Senator Mattingly. I know you have worked on this a long time; and as you mentioned, you were anxious to put it on the imputed interest when we were dealing with that, and you withheld so that this committee would have a chance to look at it. You have vigorously pursued it, and I recognize that, and we will try to move rapidly ahead.

Senator MATTINGLY. Thank you. Mr. Chairman, would you also include in the record a copy of a report of the analysis of cooperative taxation prepared by the USDA?

Senator CHAFEE. Yes, we will do that also.

Senator MATTINGLY. Thank you.

[The prepared written statement of Senator Mattingly and the proposed amendment and the report of the USDA follow:]

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STATEMENT BY MR. MATTINGLY

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

SENATE COMMITTEE ON FINANCE

MONDAY, JULY 15, 1985

THANK YOU MR. CHAIRMAN. I FIRST WANT TO THANK THE SUBCOMMITTEE FOR ARRANGING THIS HEARING IN SUCH A PROMPT AND COOPERATIVE MANNER. AS WE ALL RECOGNIZE, THE TOPIC WE ARE DISCUSSING TODAY IS OF GREAT IMPORTANCE TO THE NEARLY 2 MILLION MEMBERS OF OUR NATION'S FARMER-OWNED COOPERATIVES. I MIGHT ADD THAT THIS ISSUE IS OF SOME URGENCY TO CO-OPS WHICH ARE IN IMMINENT DANGER OF BEING TOLD BY THE INTERNAL REVENUE SERVICE THAT THEY MUST GO BACK INTO PAST YEARS AND PAY TAXES, PENALTIES AND INTEREST BECAUSE THEY UTILIZED THE PRACTICE OF "NETTING" THEIR GAINS AND LOSSES AMONG THEIR SEVERAL AREAS OF COOPERATIVE BUSINESS ACTIVITY FOR THE PURPOSE OF DETERMINING THEIR TAXABLE INCOME.

THIS PRACTICE OF OFFSETTING PROFITS MADE IN ONE AREA OF BUSINESS ACTIVITY AGAINST LOSSES INCURRED IN ANOTHER AREA OF ACTIVITY CONDUCTED BY THE SAME ORGANIZATION IS NOT AN EXCEPTION TO THE RULE...INDEED, IT IS A PRACTICE AVAILABLE TO ALL TYPES OF BUSINESS ENTERPRISES WHETHER THEY BE SOLE PROPRIETORSHIPS, PARTNERSHIPS OR CORPORATIONS. THE U. S. TAX COURT HAS DISTINCTLY FOUND THAT FARMER-OWNED COOPERATIVES ARE ALSO ELIGIBLE TO EMPLOY THIS SAME PRACTICE OF NETTING GAINS AND LOSSES AMONG THEIR SEVERAL DIVISIONS FOR TAX PURPOSES.

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DESPITE THE CLEAR AND UNAMBIGUOUS LANGUAGE USED BY THE TAX COURT IN OVERTURNING THE I.R.S. POSITION AGAINST CO-OP NETTING, WE FIND OURSELVES TODAY FACED WITH YET ANOTHER ATTEMPT BY THE SERVICE TO CHANGE THE LAW BY ADMINISTRATIVE FIAT. NOW, MR. CHAIRMAN, I RESPECT THE FACT THAT BOTH YOU AND CHAIRMAN PACKWOOD WERE SOMEWHAT CONCERNED WHEN I EARLIER ATTEMPTED TO INTRODUCE AMENDMENTS TO RECTIFY THIS PROBLEM. I UNDERSTAND AND EVEN APPRECIATE YOUR COMPLETELY PROPER ACTIONS TAKEN TO PRESERVE THE JURISDICTION OF THE COMMITTEE AND THE INTEGRITY OF SENATE PROCEDURE. HOWEVER, I CAN ONLY SPECULATE ABOUT THE KINDS OF THOUGHTS WHICH MUST PASS THROUGH YOUR MINDS WHEN AN EXECUTIVE BRANCH AGENCY SUCH AS THE I.R.S. BLATANTLY ATTEMPTS TO COMPLETELY CIRCUMVENT NOT ONLY THIS COMMITTEE, BUT THE ENTIRE CONGRESS. THEIR CAVALIER ATTITUDE HAS OBVIOUSLY RAISED THE CONCERN OF AT LEAST THIRTY-TWO OF OUR SENATE COLLEAGUES WHO HAVE EITHER ADDRESSED THEIR COMPLAINT TO SECRETARY BAKER OR WHO SIGNED ON AS CO-SPONSORS OF THE AMENDMENT WHICH I HAD EARLIER INTENDED TO INTRODUCE TO THE IMPUTED INTEREST BILL. I WOULD JUST NOTE THAT AMONG THE THIRTY-TWO WERE SEVEN MEMBERS OF THE FINANCE COMMITTEE. MR. CHAIRMAN, I HAVE COPIES OF THOSE TWO LETTERS AND I WOULD ASK THAT THEY BE ENTERED IN THE RECORD OF THIS HEARING AS THOUGH FULLY READ.

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MR. CHAIRMAN, YOU ARE ALSO AWARE OF THE CONCERNS EXPRESSED BY SECRETARY BLOCK OVER THE I.R.S. ACTIONS. HE TOO HAS EXPRESSED HIS FEELINGS ON THIS ISSUE TO BOTH SECRETARY BAKER AND TO THIS COMMITTEE. I WOULD ASK THAT COPIES OF HIS LETTERS ALSO BE ENTERED IN THE RECORD AS THOUGH READ IN THEIR ENTIRETY. U.S.D.A. HAS STUDIED THIS ISSUE UNDER SEVERAL ADMINISTRATIONS, AND SECRETARY BLOCK'S LETTERS OF SUPPORT ARE BASED ON THE RESULTS OF INTENSIVE STUDIES CONDUCTED OVER THE YEARS. 1980 U.S.D.A. PREPARED AN UPDATED ANALYSIS OF THE ISSUE WHICH I THINK THE SUBCOMMITTEE WILL FIND VERY ENLIGHTENING. I WOULD SUBMIT A COPY OF THAT 1980 U.S.D.A. REPORT FOR THE RECORD, MR. CHAIRMAN, AND ASK THAT IT BE PRINTED THEREIN.

AS I HAVE INDICATED IN MY EARLIER STATEMENTS ON THIS ISSUE, WE ARE HERE TODAY TO SIMPLY SEEK FAIRNESS AND EQUITY FOR OUR FARMER-OWNED COOPERATIVES IN THE APPLICATION OF THE TAX CODE. WE DO NOT ASK THAT THE STATUTE BE CHANGED, ONLY THAT LANGUAGE BE ADDED WHICH MAKES PERFECTLY CLEAR TO THE I.R.S. WHAT THE TAX COURT HAS TRIED TO TELL THEM ON THREE DIFFERENT OCCASIONS...THAT FARM CO-OPS ARE ENTITLED TO USE NETTING PROCEDURES IN DETERMINING PATRONAGE DIVIDENDS FOR TAX PURPOSES. ONE WOULD THINK THAT SUCH LEGISLATIVE ACTION WOULD BE UNNECESSARY GIVEN THE RATHER BLUNT LANGUAGE FOUND IN THE COURT DECISIONS. UNFORTUNATELY, THE

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SERVICE SEEMS RATHER PRONE TO SELECTIVE DEAFNESS WHEN ANYONE TELLS THEM SOMETHING THEY DON'T WANT TO HEAR.

MR. CHAIRMAN, I AGAIN THANK YOU THE THE STAFF FOR KINDLY ACCOMMODATING US HERE TODAY. I WOULD REQUEST THAT THE SUBCOMMITTEE ACT AS EXPEDITIOUSLY AS POSSIBLE IN REPORTING LANGUAGE SIMILAR TO THAT WHICH WAS CONTAINED IN MY PROPOSED AMENDMENT, AND I WOULD ASK THAT A COPY OFTHE AMENDMENT BE INCLUDED FOR THE RECORD AS THOUGH READ. WE URGE YOUR CONTINUED ASSISTANCE IN THIS EFFORT TO PUT AN END TO WHAT THE COURT REFERRED TO IN ONE DECISION AS THE I.R.S.'s "...UNWARRANTED TINKERING WITH THE TAX STRUCTURE APPLICABLE TO COOPERATIVES."

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AMENDMENT NO. _____ Ex. _____ Calendar No. _____

Purpose: To amend the Internal Revenue Code in order to clarify the right of agricultural cooperatives to net earnings and losses from different lines of business when computing taxable income.

IN THE SENATE OF THE UNITED STATES— 99th Cong., 1st Sess.

S. _____

H.R. 2475 (or Treaty _____)

(Title) A bill to amend the Internal Revenue Code to simplify the imputed interest rules of sections 1274 and 483, and for other purposes.

( ) Referred to the Committee on _____ and ordered to be printed

( ) Ordered to lie on the table and to be printed

INTENDED to be proposed by Mr. Mattingly, for himself and Mr. Abdnor, Mr. Nunn, Mr. Zorinsky, Mr. Cochran, Mr. Thurmond, Mr. Heflin, Mr. Helms, Mr. Boren

Viz: Mr. Nickles, Mr. Denton, Mr. East, Mr. Trible, Mr. Dixon, Mr. Warner, Mr. Boschwitz, Mr. Pressler, Mr. Harkin, Mrs. Kassebaum, Mr. Hollings, Mr. HARKIN, Mr. Gramm, Mr. Quayle, Mr. KASTEN, Mr. Symms & Mr. Grassley.

At the end of the bill add the following new section:

"Sec._____. (a) The Internal Revenue Code is amended by adding the following new sentence at the end of section 1388(a):

'For any year to which this subchapter applies, when an organization computes its net earnings from business done with or for patrons, losses in one or more of the organization's allocation units (whether functional, divisional, departmental, geographic or other) may be offset against earnings from business done with or for patrons in one or more allocation units of the organization.'.

(b) The Internal Revenue Code is amended by renumbering subsection (5) of section 521(b) as subsection (6) and inserting a new subsection (5) as follows:

'(5) NETTING OF LOSSES.--Exemption shall not be denied any such association because it offsets losses incurred in either its purchasing or marketing operations against earnings incurred in either its purchasing or marketing operations for purposes of computing its net earnings available for distribution to its patrons for any year to which this section applies.'."

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ANALYSIS OF COOPERATIVE TAXATION

SAFE HARBOR PROPOSALS

U.S. Department of Agriculture

September 1980

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ANALYSIS OF COOPERATIVE TAXATION SAFE HARBOR PROPOSALS

I. Introduction

Farmer cooperatives were given special tax treatment in the earliest income tax laws enacted in the United States. The treatment was essentially an exemption for some cooperatives and single tax treatment for others. In 1951 Congress attempted to define further the tax treatment of cooperatives to impose a single tax on net margins returned to patrons. Court decisions several years later, however, defeated the purposes of the 1951 Act, and some income escaped taxation where patronage refunds were retained for capital purposes.

In 1962 the Internal Revenue Code was modified to ensure fair application of tax laws to cooperatives and to achieve the single tax objectives attempted earlier. Subchapter T was added to the Code to define the single tax treatment goals established by Congress. In practice, the Subchapter T rules were found to be workable both by the Internal Revenue Service charged with their enforcement and by cooperatives attempting to comply. Those rules permitted the range of activities, accounting methods and financing techniques necessary for effective cooperative conduct to prevent tax abuses.

Principles of tax law with regard to cooperatives were well settled and consistently applied following institution of the statutory single tax in 1951 with the exception of the noncash valuation problem. The 1962 amendments clarified this one remaining issue.

In the late 1970's, however, several new theories were developed by the Internal Revenue Service about cooperative operation and the proper application of Subchapter T to cooperatives. These theories were initially

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expressed in a number of articles advocating greater IRS scrutiny of entities seeking Subchapter T status to determine whether they were, in fact, "operating on a cooperative basis," as the statute requires. Application of this new approach was tested in several recent cases in which courts generally rejected the IRS position, sometimes in rather forceful terms.

> We, as an appellate court, are not here to decide what is the most "fair" for the members of Peninsula and we seriously question whether that is properly within the province of the IRS either. 4/ We sit only to decide whether Peninsula is a tax-exempt mutual organization. Even assuming that Peninsula's system is unfair to some members, it is the members themselves, utilizing their equal voting power, who should change it, if that is their wish and if they can muster the strength.
>
> ---
>
> 4/ In a very real sense the "fairness" principle has already been decided by the Washington Legislature, the terms of the articles and bylaws and the members of this mutual company.
> --Peninsula Light Co., 552 F.2d 878 (9th Cir. 1977) (Footnote by the Court).
>
> There is some doubt whether the Commissioner has sufficient standing to object to the taxpayer's method of allocating what would normally be income excludable to the taxpayer among its member-patrons in a manner apparently acceptable to such members as an equitable distribution of profits.
> --Pomeroy Cooperative Grain Co., 388 F.2d 326 (8th Cir. 1961).
>
> We fail to see any legitimate interest of [IRS] in the mechanics of petitioner's allocation of losses among its past, current, or future member-patrons.
> --Associated Milk Producers, Inc. 68 T.C. 729 (1977).
>
> In Associated Milk Producers the Commissioner sought to deny the net operating loss carry forward for all members, while here he would deny it only for terminated members. In rejecting his argument in Associated Milk Producers, we stated that his position was "not only contrary to the express provisions of section 172, but conceptually strained and lacking any fundamental policy support: in short, an unwarranted tinkering with the tax structure applicable to cooperatives." 68 T.C. at 736. We think this characterization is equally applicable to respondent's arguments in this case.
>
> The "operation at cost" principle describes a feature of a cooperative's relations with its members, not a codified requirementof tax accounting. Accordingly, we reject respondent's argument that the principle of "operating at cost" absolutely bars

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a cooperative from carrying forward and deducting losses allocable to its terminated members.
--Ford-Iroquois FS, Inc., 74 T.C. No. 88. (Sept. 9, 1980).

In late 1978 USDA prepared a memorandum in response to a tentative IRS proposal to prohibit cooperatives with more than one department from netting gains and losses across departmental lines in calculating patronage dividends. The memorandum, submitted to IRS, discussed the proposal fully and explained the reasons for USDA opposition. We have reviewed the premises, rationales, and conclusions presented in our 1978 paper and find them still valid. 1/

On June 13, 1980, Donald C. Lubick, Assistant Secretary, Department of the Treasury, transmitted a preliminary memorandum to the Department of Agriculture that outlined some rather strict tax rules which would be applied to cooperatives in accordance with the new view of cooperative taxation advocated in the past few years by the IRS. The rules would greatly restrict the situations in which netting across departmental lines could occur. In addition, the memorandum proposes a "safe harbor" approach which would define certain netting practices acceptable to IRS. A cooperative which adhered to the very specific requirements of the safe harbor proposal would be protected against further IRS scrutiny of its netting practices. The IRS memorandum invites USDA comments both generally and on specific topics. Our response to this memorandum follows.

1/ Ten years earlier, in 1968, IRS had proposed a rule that would have had the opposite effect. At that time the proposal was to require cooperatives to offset losses against gains across departmental lines in calculating net margins allocated to patrons. USDA opposed that proposal as well.

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A. The Issue--In Brief

Interunit netting (also called interdepartmental netting) occurs when a cooperative that provides several different services to its patrons through two or more units combines the margins and losses from its various units and does not treat each unit as a completely separate cooperative operation. 2/ A loss occurs when a cooperative's expenses exceed its gross income and the cooperative does not require patrons to make up the difference during that same tax period. The strict view by some officials in the Internal Revenue Service is that an organization "operating on a cooperative basis" is neither permitted to net across units nor incur a true loss. It is this view with which the Department of Agriculture disagrees.

B. The Problem

The Internal Revenue Service must determine, as a practical matter, which organizations are governed by Subchapter T rules. Interpretation of "operating on a cooperative basis" is critical to this task. Also, as a practical matter, general principles and definitions must be reduced to some workable rules that can be applied in individual cases by IRS agents as they enforce the income tax laws.

Differences of opinion on such rules are serious, and their resolution will have significant consequences for farmer cooperatives and farmer patrons. These differences of opinion have focused on interunit netting practices and loss treatment, though the scope of the IRS' safe harbor proposal suggests that the IRS also views numerous other structural and

2/ A cooperative may, after netting across departmental or unit lines, elect to pay refunds to all members on a patronage basis or simply to members of units which generated net margins during the year.

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functional characteristics of cooperatives as subject to scrutiny for tax abuse potential.

The present memorandum supplements the comments and views articulated in an issue paper entitled Cooperative Interunit Netting prepared in 1975 by USDA's Economics, Statistics, and Cooperatives Service and submitted to the Assistant Secretary of Treasury and to personnel of the IRS.

The present paper consists of four parts. First, some general observations are made to place the issues in perspective. Second, we respond to specific questions, though our information on some items is inadequate to provide all information requested. Third, we address, as requested, the safe harbor portion of the memorandum. Fourth, we offer some general conclusions regarding the approaches to cooperative taxation contemplated in the memorandum.

II. General Observations

A. USDA's Perspective

It is not the purpose of USDA to advocate "liberal" or "easy" application of tax laws to cooperatives. To the contrary, it has been our experience that cooperatives operate well when tax laws are applied carefully and thoroughly.

USDA, in fact, tends to take fairly strict views of what constitutes operation on a cooperative basis. It is with these firm requirements in mind that our response is drafted.

Second, USDA does not wish to address technical discussions of tax law application. Such functions are correctly left to the expertise of the IRS. We feel very strongly, however, that the issues addressed in the new tax position with respect to interunit netting are not essentially technical in

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nature. They are, rather, major policy decisions that we believe deviate markedly from Congress' view of cooperatives, the views of cooperatives held by scholars of cooperative enterprise, as well as from concepts of cooperatives held by those who create and use cooperatives.

Finally, it is not our intent merely to balance practicality against principles. Where a cooperative principle requires a certain course of conduct, the difficulties associated with it must be accepted as a burden of doing business cooperatively (and there are numerous such burdens).

It must be carefully understood and appreciated, however, that cooperative concepts and principles developed from practical experience and needs in the "real world." Principles followed by the Rochdale Pioneers of 1844, often viewed as the first collection of cooperative principles, were rules for successful business, not theoretical ideals. Likewise, in the United States, the principles devised by the Patrons of Husbandry in 1876 were adopted specifically to strengthen foundering local Granges. Our conclusion must be that when "principles" are devised and applied in such a manner as to make true cooperation impossible, something is amiss with the "principles," not with the legitimacy of the cooperative.

B. Restatement of General Principles

1. Basic Cooperative Taxation. Subchapter T of the Internal Revenue Code applies a single tax principle to "any corporation operating on a cooperative basis." This rule is not restricted to agricultural cooperatives.

The cooperative must pay tax at the ordinary corporate rate on any income not based on patronage or not returned or allocated to the patrons. The only difference in treatment between cooperatives and non-cooperative corporations is that Subchapter T permits a cooperative to deduct patronage refunds from

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its net income before paying taxes. (In certain limited circumstances described in section 521 some farmer cooperatives may receive additional deductions.)

Under Subchapter T rules, a cooperative may retain up to 80 percent of the net margins as patron capital with the patron's permission. The capital must be allocated to the patron, however. It is not treated as income to the cooperative but rather is taxable income to the patron with a concurrent capital investment in the cooperative. It does not escape taxation.

Currently accepted tax principles extend the single tax treatment of Subchapter T only to those cooperatives which have no authority to retain for their own use, without the consent of their patrons, net margins generated by the patrons' business. The fact that the cooperative may guide the net margins to various patrons on the basis of their business with the cooperative does not give the cooperative possession of those net margins for its own use. This concept of cooperative taxation, which we deem fundamental, will be noted again.

2. Cooperative Principles. The cooperative form of business enterprise is defined and distinguished from other forms of business by the set of relationships that exist between the members and their cooperative, and among the members. These relationships are usually summarized as "cooperative principles," established by custom and usage, historical development, and scholarly and legal documents (though not in Subchapter T).

The disagreement over permissible cooperative interunit netting, though one over application of specific tax rules, is based on a difference of

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opinion on fundamental cooperative principles, represented on the one hand by a strict view apparently adopted in the safe harbor memorandum and on the other hand by more generally held views of cooperative representatives, experts, scholars, and all legislation at both State and Federal levels defining and regulating cooperatives.

The single most comprehensive statement in law that combines all cooperative principles is that a cooperative is an organization operated "for the mutual benefit of its members." This implies three principles. First, the cooperative must be owned and controlled by members. A number of equitable voting procedures are in use to exercise this control; among them are one vote per member and voting based on amount of business done with the cooperative. Second, returns to capital are limited, thus restricting benefits gained from the coopertive to those who use and control it. Finally, the excess of gross income over expenses belongs to member patrons or all patrons in proportion to their use of the cooperative, sometimes called the "operation at cost" principle.

C. The Conduit Concept

The analogy of a cooperative to a conduit has been used frequently. Though simple in form, the analogy may be useful to demonstrate the above noted principles.

The cooperative entity is viewed as a hand holding a pipe. Net margins enter the pipe at the top, pass through the conduit, and are returned to patrons at the bottom of the pipe. A narrow view of a cooperative that would require tracing patronage refunds back to the transaction that gave rise to

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the net margin would visualize a bundle of pipes, each one passing a particular part of the net margin back to a particular patron.

Another view of the conduit concept would visualize a single pipe passing the net margins (by its terms an aggregate amount) back to the patrons. The conduit concept of a cooperative permits either approach, including intermediate cases where each unit is represented by a separate pipe.

The member patrons control the hand that directs the pipe or pipes. Likewise, the patrons direct the hand as to how many pipes are used and how they are used to direct the flow of funds through the cooperative.

In every case, however, the funds flow through the pipes—they cannot be grasped by the hand holding the conduits. This is the essence of the single tax rule.

Because the hand itself (the cooperative entity) cannot take possession of the funds for its own use, it should not be taxed as if it could.

So long as the hand (the cooperative itself) cannot possess the money flowing through the pipes, requirements for single tax treatment have been met. There is no need to analyze how the members control the hand so long as the right to control rests solely with those at the end of the conduit. There is no need to analyze the size of the pipes or how many patrons are included in each pipe.

Subchapter T requirements are met when:

1. The conduit system is controlled by members at the end of the pipe.

2. Returns that flow through the pipe or pipes are based on net margins generated at the top of the pipe by patrons at the bottom of the pipe.

3. Returns come to patrons in proportion to amount of business done with the cooperative.

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4. The funds flow through the conduit, however directed, and not into the hand holding the pipe.

The primacy of the single tax rule and the view that the single tax rule is applicable so long as the cooperative, as an independent entity, may not maintain possession for its own benefit of the net margins to be passed back to patrons, lead to a tax policy that seems to relieve the IRS of many enforcement burdens discussed in the safe harbor memorandum. Our view is that when cooperative members have the absolute right to control their organization, when that organization passes net margins back to patrons on the basis of business done with the cooperative, and when the organization itself cannot maintain possession of the net margins for its own benefit, the single tax rule should apply. Detailed analysis of voting habits, netting practices, equity redemption practices, etc., are neither relevant nor necessary for tax enforcement purposes.

D. Two Views of Cooperative Principles

Because "operating on a cooperative basis" is not further defined in the Internal Revenue Code, workable enforcement rules must be derived from cooperative principles. The manner in which these cooperative principles are applied will determine whether two particularly important and presently widespread cooperative practices are permitted or prohibited in the future. One is netting of margins and losses among separate allocation units (departments or branches) within a single cooperative; the other is the ability of cooperative organizations to incur true losses.

Many cooperatives perform several different services for their members. Each type of service may be performed for a somewhat different group of

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patrons and may have a different net margin in any given tax year, or some may have net margins while others suffer a net loss. The "netting" issue questions to what extent net margins in one unit may be combined with a lesser net margin or a loss in another unit. The "strict" view of some tax officials is that such netting is not "equitable" to patrons and violates the "operating on a cooperative basis" requirement. Because margins must be returned to patrons in proportion to business done with the cooperative, this view holds that patronage refunds must also be based on margins generated by that business, not business done with other patrons. The "general view" of most cooperative representatives and scholars is that the members themselves must determine what is an equitable allocation of margins and losses for them. This allocation may vary with particular cooperatives under a wide range of circumstances. The strict view, based on idealistic cooperative theory, is not practical.

The strict view on losses holds that because cooperative operation requires that net margins be returned to patrons on the basis of the patronage generating the margins, cooperative principles prohibit a cooperative from incurring a true loss for certain tax purposes. In that view the loss must be made up by patrons with direct assessments or current reserve reductions as if it were a "negative" net margin, and it is impermissible to have a net operating loss that can be carried to either prior or subsequent years in accordance with tax practices available to all other corporations. This method of handling losses is prescribed in section II B of the safe harbor, and we discuss it more fully in our specific comments on the safe harbor. The

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general view is, however, that the members themselves should decide how to recoup losses and may use ordinary loss rules applicable to other corporations in so doing.

The interdepartmental netting question is technically separate from the loss question. However, the same differences of opinion over cooperative principles and equitable treatment are the bases for both issues. In addition, most litigated netting problems have been generated by a dispute over the status of a loss in one unit as compared to a net margin in another rather than netting positive margins in each unit.

Refusal to apply ordinary loss rules to cooperatives is a position logically consistent with the IRS proposal to disallow interunit netting and, as noted above, it is the position that the IRS appears to take in its safe harbor proposal. Like the disallowance of netting, however, failure to recognize true losses would severely restrict the financial flexibility of cooperatives with no consequent benefit to the tax system.

E. Perceived Abuses

The examples used in the section of the IRS memorandum on potential abuses in cooperative operations, and the conclusion that extensive changes in tax policy may be justified to prevent such abuses, are somewhat disturbing.

In section A (pp. 4-7 of the safe harbor memorandum) no example of an abuse of tax law is given that is not now strictly prohibited by court

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decisions with which we agree. 1/ We do not understand how this recitation of pronibited practices mandates application of new tax principles to existing practices that are not abuses.

In section B (pp. 7-9 of the memorandum) no cause and effect relationship is defined between the structure or practice mentioned and an abuse of tax laws. If abuses are found, they can be prevented under present tax laws. Practices that have legitimate cooperative business purposes should not be subjected to scrutiny where tax abuses do not follow from them. In the extreme, every action by a cooperative and every cooperative structural and operational characteristic may conceivably be a precursor to an abuse of tax laws. The tone of the section on abuses seems to reach in the direction of scrutiny of all these characteristics even though the tax statute (Subchapter T) singles out only the patronage refund relationship as a relevant subject for taxation purposes.

F. Present Status of the Law

A survey of IRS rulings on the netting and loss issues shows a somewhat mixed approach to the variety of circumstances under which cooperatives operate. Some rulings have recognized the need to net across units while others have severely restricted such practices.

1/ The Farm Service case, discussed in greater detail later in this paper, prohibits netting of margins and losses between units doing patronage and non-patronage business by non-exempt cooperatives. However, in the case of exempt cooperatives, the Code specifically allows a deduction for nonpatronage sourced earnings returned to patrons. There is no abuse of the tax laws because cooperatives that meet the strict requirements of Section 521 are entitled to single tax treatment of such earnings.

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A recent Tax Court decision, however, addressed the netting and loss issues and specifically rejected the strict IRS position. In a 1977 case the Tax Court said of the loss issue:

> We consider [IRS's] position herein not only contrary to the express provisions of [the Code] but conceptually strained and lacking any fundamental policy support; in short, an unwarranted tinkering with the tax structure applicable to cooperatives. The deductions claimed are clearly authorized by section 172. There is nothing within that section or the regulations thereunder which indicates that the net operating loss deduction is not applicable in the case of a cooperative subject to subchapter T. In fact, quite to the contrary, the utilization of the net operating loss deduction by cooperatives is clearly implicit in certain subsections of the Code and the Income Tax Regulations, and in various of [IRS's] rulings dealing with cooperatives.... We fail to see any legitimate interest of [IRS] in the mechanics of [the cooperatives's] allocation of losses among its past, current, or future member-patrons.... [IRS] has referred to no compelling policy considerations or dangers of tax avoidance which might even warrant an attempt to deny such carry over in the face of the clear language of [the Code].
> —Associated Milk Producers, Inc., 68 T. C. 729 (1977)

C. The Department's Position and Reasoning

The Department of Agriculture supports sound application of proper tax principles and rules to farmer-owned cooperatives. It appears that such application could be defeated by the misconception of cooperative principles and practices as reflected in the strict view of some Federal officials, with a consequent impact on cooperatives unintended by Congress and contrary to usual tax revenue generation principles.

The Department's position is that no cooperative principle prohibits corporations operating on a cooperative basis from netting among units within the cooperative organization. Neither does any cooperative principle prohibit a cooperative from sustaining a loss or using ordinary loss rules available to other corporate organizations.

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On the contrary, owner-user control, operation for the mutual benefit of the members, and the nonprofit nature of cooperatives require that members themselves decide what is equitable for them as they use their cooperative. Because each organization is different, and each member has different needs, equitability requires flexibility, and nonnetting or nonloss rules do not satisfy that requirement.

The Department bases its adherence to the more generally held view on a number of points that fall broadly into five categories outlined below.

1. Interunit Netting Serves The Mutual Interests of Patrons. All of the specific, economic justifications for the practice of interunit netting presented below are really expressions of the fundamental concept of cooperatives, recognized throughout the law of cooperatives and the principles of cooperation—that the members stand in a mutual relation with each other. This concept is so basic to cooperatives and the law of cooperatives and is so significant to the netting issues, that it deserves special comment.

The importance of this concept of mutuality is manifested in numerous ways. Many laws governing cooperatives explicitly state they are to be conducted for the mutual (not individual) benefit of the members. Members are placed in a group—they are not treated as "customers" independently of other members. In addition, where patronage marketing contracts are used by a cooperative, there is a contractual obligation not only between the individual member and the cooperative but among the members. This unique mutual relationship among members makes it impossible to isolate any member's or a group of members' transactions to determine their "value," as is contemplated in the IRS concept of cooperation. Moreover, a majority of State statutes

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governing cooperatives provides that the detriment caused by an individual member's breach of a marketing agreement is spread across the entire membership.

Statutory material and court decisions on mutuality of benefits and responsibilities, and the interdependence of members, are numerous, extending back to the turn of the century. We find it somewhat disturbing that this concept has been neglected in the safe harbor memorandum's views of true cooperative operation.

USDA views netting as a useful, necessary, entirely legitimate practice among cooperatives that operate for the mutual benefit of patrons. We describe below the wide variety of practical, "real world" justifications for netting as commonly practiced by numerous cooperatives.

(1.) Agricultural production and distribution are subject to considerable volatility and uncertainty. These, in fact, are among the important economic characteristics of agriculture. A major purpose of cooperation among farmers has historically been to alleviate disastrous effects upon certain groups of farmers. Diversification of risk by netting gains and losses among several patron units may permit a cooperative to reduce significantly the effect of catastrophic failure in any one of them, and avoid a complete failure of the entire cooperative.

The multiunit cooperative has developed in some degree as a reaction to repeated failures of single-unit cooperatives that were unable to survive a period of lean years in the limited sector of farming which they served. The success of American cooperatives today is thus due, at least in part, to increased diversification, multiple activities and a wide variety of netting practices.

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(2.) Different units of a cooperative may provide each other with benefits not reflected in the gains and losses on a balance sheet. There may well have been some reason that benefits of the "gain unit" were derived from operation and existence of the "loss unit." Without the loss unit, the gain unit may not have been successful. Examples would be availability of credit based on total cooperative operation; enhancement of cooperatives' service to users through full service lines; complementarity of market lines; efficiency of plant, pickup, purchasing, distribution systems, information systems, and other efficiencies based on optimal value of service lines; and countless others.

(3.) Members of a unit that suffers a loss may have contributed considerable capital to the organization over time, and the benefits of the capital contribution of patrons of each unit can seldom be separated by units. The cooperative is an entity. Its capital structure is a unitary structure. The benefits to the whole cooperative, and therefore to all of its members, from the capital contribution of members of a losing unit cannot be measured by simple accounting procedures. Thus, it could well be that the true benefits attributable to members of gain units are overestimated by simple patronage refund measures, and the benefits attributable to members of losing units are underestimated. The concept of the cooperative as a mutual effort of all members might well require netting across units to reflect the true contribution of members of each unit.

(4.) Many members and patrons contribute capital by retained patronage refunds in proportion to business done with the cooperative. Where a member, for example, does one-fiftieth of the cooperative's business, one-fiftieth of the capital is contributed by that patron. If, however, netting is not permitted, members of "loss units" would receive no patronage refunds and

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would make no contribution to capital for the period of the loss. Thus the system of capital contribution in proportion to business done with the cooperative would be undermined. The loss unit members would bear no burden in financing the cooperative while the gain unit members shouldered the entire burden.

Capital retirement programs likewise may be adversely affected if netting is not used. Under a revolving fund plan of financing (widely used by all kinds of cooperatives) old capital is revolved out as new capital comes in. It is usually revolved out based on date of contribution. As noted above, the capital structure of a cooperative is a unified whole based on the legally defined entity character of the cooperative. If netting is not permitted, capital contributions by gain unit members may be revolving out old capital contributions by loss unit members. Where this occurs over a period of time, several undesirable results may follow. First, the members of the loss unit begin to lose a stake in their cooperative and do not bear their fair responsibility of cooperative finance. Second, the capital structure becomes fragmented, with more and more gain unit member capital supporting all cooperative operations. Finally, when the loss unit becomes a gain unit and loss unit patrons make capital contributions, their capital will be used to revolve out gain unit capital. Where netting is used, capital is contributed and revolved in proportion to business done with the cooperative—a legitimate and desirable goal of cooperative operation.

(5) It appears to us that the IRS memorandum fails to recognize one of the basic features of a farmer cooperative (and perhaps nonfarmer cooperatives under appropriate circumstances). That principle is that the benefits of the

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cooperative accrue to the members' own enterprises. In fact, farmer cooperatives are often referred to as extensions of the farm enterprise "beyond the farm gate."

This fundamental concept implies that there are two sources of benefits to the member from cooperative operation. First, where better prices are associated with supplies purchased or products marketed through the cooperative, a cash saving is made that benefits the farmer. Second, an assured supply of quality inputs or an effective marketing system for products produced will make the farming operation more profitable and desirable.

A common statement in the State statutes will demonstrate this distinction and show its common recognition in the law governing many cooperatives' operations. It states that cooperatives "shall be deemed 'non-profit,' inasmuch as they are not organized to make profit for themselves, as such, or for their members, as such, but only for their members as producers." We believe this statement of public policy is significant and must be taken into account when internal cooperative practices are analyzed.

The total benefit to a member from doing business with a cooperative is the sum of two figures--the net margin allocated to the member and the increased profit to farming operations made possible by the presence of and services provided by the cooperative.

Thus, to determine if the total benefit to members associated with loss and gain units is greater or less with netting, the total production-cooperative system must be analyzed. What appears to be a "subsidy" may in fact simply be a balancing of total benefits of cooperative efforts when the true function of a cooperative--operation for the benefit of

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members as producers—is recognized. Cooperative members make the decisions and are in a unique position to do so because they, as individual producers, can analyze their own benefits from the cooperative. We as outsiders would find it impossible, even with sophisticated economic data and analytical techniques, to substitute our estimate of benefits to members for estimates made by the members themselves. Consequently, a conclusion that members of a gain unit are "subsidizing" members of a loss unit because one aspect of cooperative benefits—patronage refunds—are shared among the members would be very suspect. Further, a conclusion that member control has failed, that some principles of fairness have been violated or that such sharing is somehow an abuse of tax laws would be unjustified.

To summarize, there are numerous reasons why cooperative members may wish to net across units. Members of a cooperative have a common obligation to finance their cooperative, common ownership of assets through the corporate entity, common voting control, common directors, common management, common planning horizons, common liabilities for debts and damages, etc.

We do not wish to suggest that there is never a "subsidy" effect among units. We do believe that there is nothing inherently undesirable with such a subsidy where it in fact exists. Members might simply want common rights to share net margins. The reasons for netting listed above are by no means the only ones. The list is only a suggestion of the range.

2. Interunit netting is permissible under cooperative principles. None of the three major principles of cooperation—member ownership and control, limited returns on investment, and return of net margins to patrons in proportion to their use of the cooperative—prohibits interunit netting.

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Equitability and operation at cost considerations must guide cooperative members as they conduct their affairs, but interunit netting may be the best way to achieve true cooperative equity. The member ownership and control requirement means that members themselves must make equitability decisions according to the nature of their cooperative, the members' own individual enterprises and the members' goals of cooperation.

3. Restrictions on interunit netting are not necessary to facilitate the revenue collection function of IRS. An organization must be operated on a cooperative basis to meet Code requirements for single tax treatment, and IRS must apply that criterion to cooperatives asking for such treatment. However, interunit netting is permissible under cooperative principles, and it is therefore inappropriate to use the practice as a definitional criterion in assessing cooperative status. General equitability principles do not preclude interunit netting. By the same token, they provide no other readily measurable standard for determining whether a legal entity is truly a cooperative. Nevertheless, in making such determinations, IRS need not probe the internal affairs of the cooperative. IRS can look to owner use and control, overall operation at cost and limited returns on investment as hallmarks of operation on a cooperative basis. Interunit netting is an internal cooperative practice with no impact on tax revenues. It is not a method to reduce or avoid payment of taxes.

4. New interunit netting restrictions would unnecessarily restrict farmers' cooperation among themselves. Though difficult to measure, impacts on cooperatives resulting from the proposed restrictions on netting would include the following:

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--Farmer-members would lose the autonomy they now have to make decisions about equitable sharing of cooperative benefits and burdens. Federal government standards would be substituted.

--Farmer-members would not be able to share benefits and risks according to mutual benefit principles.

--Membership would become fragmented because the mutual interests of separate member groups would be minimized.

--Membership financing methods would be considerably more difficult in a number of circumstances, such as start up of new services to farmers by addition of a new unit or support of a risky unit that provides a needed service. The safe harbor memorandum recognized these problems, but reached no conclusion about the extent of exceptions to the general position against netting that would be necessary to resolve the problems.

--Access to financing that a larger pool of income generating units has would be limited if the pool were fragmented by restrictive tax rules.

--Further burdens to cooperative accounting would be added to already detailed record keeping requirements.

--The most serious immediate threat of applying theoretically based strict rules to cooperatives would be loss of Subchapter T status. Data are scarce on the prevalence of netting and losses, but we believe it to be common. Strict application of the ideas expressed by some in IRS would subject the internal activities of every cooperative that could not or would not meet the safe harbor standards to IRS agents' scrutiny and possible loss of cooperative tax status.

5. Restrictive interunit netting rules would single out cooperatives and would apply to them requirements not imposed on ordinary corporations.

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Noncooperative corporations are taxed as entities after all internal gains and losses from all profit centers have been combined. Individual departments cannot be taxed separately and the gain or loss position of each department is irrelevant for tax purposes. This same rule should apply to cooperative corporations. The clear purpose of Code provisions pertaining to cooperative corporations was to establish a single tax principle for net margins returned to patrons, not to require or permit tax officials to look into all of the organization's internal operating methods to determine Subchapter T eligibility. The entity concept of corporations should not be disregarded for cooperative corporations.

H. Cooperative Netting Example

We think, finally, that it would be useful to take a simple example of a cooperative with two different units, that permits netting, and that gives the board of directors the discretion to make the netting decision after the beginning of the year. This example seems to contain the situations thought to be sources of tax abuse in the safe harbor memorandum.

The example is given and the elementary rules of Subchapter T are applied to see if there are any characteristics of the example that do not meet Subchapter T requirements.

The cooperative in the example is made up of six members, A through F. Members A, B, and C patronize one unit, and members D, E, and F patronize the other unit. Unit 1, patronized by members A, B, and C, markets the grain of members A, B, and C. Unit 2, patronized by members D, E, and F, markets broilers for members D, E, and F. The amount of business done with the cooperative by members A through F is measured in dollar terms.

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The proportion of business done by each member, measured in dollar amounts, is as follows:

Member	Percent
A	10
B	10
C	15
D	15
E	20
F	30

Unit 1 has a net loss in the current year of $40. Unit 2 has a net gain of $100. The net margin of the entire organization is $60.

The board of directors decides to net all income and all expenses of the organization across the two units. Further, the directors decide to pay all amounts in cash, as follows, according to the business done with the organization.

Member	Refund
A	$6
B	$6
C	$9
D	$9
E	$12
F	$18

We now look at Section 1388(a) to see if such amounts meet the definition of a "patronage dividend."

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The first sentence reads. "For purposes of this subchapter the term 'patronage dividend' means an amount paid to a patron by an organization to which part I of this subchapter applies—". The cooperative is a corporation operating on a cooperative basis, incorporated under the State statute which defines what a cooperative is. It meets all State laws and regulations concerning cooperatives, and, in addition, meets the qualifications set out for a cooperative in the Federal statutes, namely, the Capper-Volstead Act of 1922. It meets all qualifications to borrow from the bank for cooperatives in the Farm Credit System. It would be qualified to accept loans under the CCC program as defined in regulations by the USDA. Under the statute, it votes on a patronage basis in proportion to percentages shown in the tables.

Section 1388(a) further provides the amount is to be paid "(1) on the basis of quantity or value of business done with or for such patron." The amounts are paid on the basis of the value of business done with each patron as shown in the tables.

Section 1388(a) further requires that the payments be made "under an obligation of such organization to pay such amount, which obligation existed before the organization received the amount so paid." The amount paid ($60) was paid according to an existing obligation under the bylaws of the organization and under the State statutes which required the cooperative to pay its net margins to its patrons. Under no circumstances in our example could the cooperative retain for itself any amount whatsoever for its own use as income. Such obligation existed from the beginning of the organization and the adoption of its initial bylaws far in advance of the beginning of the current year.

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Section 1388(a) provides that patronage refunds be "determined by reference to the net earnings of the organization from business done with or for its patrons." Its patrons are A, B, C, D, E, and F. The net earnings of the organization ($60) were determined by reference to the net earnings of the cooperative from the business done with patrons A, B, C, D, E, and F.

Section 1388 further provides that the term patronage dividend "does not include any amount paid to a patron to the extent that (A) such amount is out of earnings other than from business done with or for patrons." The amounts paid to each member in the cooperative are paid out of earnings ($60) only from business done with or for its patrons.

Section 1388 further provides that patronage dividends do not include any amounts paid to a patron to the extent that "(B) such amount is out of earnings from business done with or for other patrons to whom no amounts are paid, or to whom smaller amounts are paid, with respect to substantially identical transactions." The purpose of this provision in the statute is to ensure that each patron receive the same proportionate patronage refund as all other patrons similarly situated. In this example, the patrons of Unit 1 have engaged in substantially identical transactions (the marketing of grain) and are treated alike. The same is true of the patrons of Unit 2 (who market broilers). The practice of netting one unit's losses against the other unit's gains preserves the principle of treating all patrons engaged in substantially identical transactions in similar fashion. The statute does not require that patrons of Unit 1 be paid the same amounts as the patrons of Unit 2, because the two units perform transactions that are not substantially identical.

We do not see any alternative possibilities for netting in our example that do not conform in all respects to the requirements of Subchapter T.

Neither do we see any tax advantage to our hypothetical cooperative by any decisions that the board of directors could make concerning the netting of the margins within the cooperative.

The single tax principle applies. Income tax is paid upon the net margin of the cooperative that is passed back by patronage refunds to patrons ($60). No net margin is retained by the cooperative under any form whatsoever that compares in any way to profits to the cooperative. We believe that a straightforward, literal reading of Subchapter T rules yields a fair result, does not permit tax abuse, and achieves all of the purposes of the single tax principle outlined in Subchapter T.

I. The Farm Service Case

The decision of the 8th Circuit Court of Appeals in Farm Service Cooperative, 619 F.2d 718 (8th Cir. 1980), is the most recent decision on netting. We analyzed that case to see if our views on interunit netting are in agreement. Although the case does not deal directly with the question of whether interunit netting of margins and losses attributable to patronage business is consistent with cooperative principles, the court's opinion does describe an approach to the problem entirely consistent with our position on this issue.

Farm Service divided its operations into four activities for accounting purposes: a broiler pool, a turkey pool, a regular pool and taxable activity. Members of the broiler pool or turkey pool had to be members of Farm Service. Members of one pool, however, did not have to be members of another. Membership in each pool, as well as membership in the cooperative, changed from year to year.

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The regular pool was not limited to cooperative members and obtained some income from nonmember patronage. The taxable activity represented the cooperative's miscellaneous income. Net margins were paid to members based on their patronage activity.

In 1971 and 1972 the broiler pool expenditures exceeded broiler pool income. Farm Service first distributed or credited patronage refunds to the turkey pool and regular pool members based on turkey or regular pool patronage. Then the regular pool income derived from nonmember business was offset with the broiler pool loss, as was miscellaneous income from the taxable activity. The remaining loss was carried back to reduce the cooperative taxable income in the 3 carry-back years to zero. Finally, the remaining broiler pool loss was allocated to the broiler pool reserve accounts, reducing the broiler pool reserves.

The Circuit Court held that income from nonpatronage sources could not be netted against patronage losses to eliminate corporate tax on the nonpatronage sourced income.

The Court stated:

> Because of [the] restriction on the scope of allowable deductions, nonexempt cooperatives must separate patronage from nonpatronage-sourced income. A nonexempt cooperative is a hybrid business organization, taxed like any ordinary corporation with respect to nonpatronage-sourced income, but like a partnership with respect to patronage-sourced income. That is to say, nonpatronage-sourced income is fully taxable to the cooperative, and, if paid out in dividends to the patron, to him as well. Patronage-sourced income is taxed only once, usually to the patron. We hold that Subchapter T requires a nonexempt cooperative to segregate its patronage and nonpatronage accounts in calculating its gross income, at least in those cases where grower payments or per unit retain allocations contribute to net operating losses in patronage activities. Likewise, Subchapter T forbids a nonexempt cooperative to aggregate

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patronage losses with its income from taxable activities, if the two are separately calculated. A nonexempt cooperative simply may not use patronage losses to reduce its tax liability on nonpatronage-sourced income.

The Court of Appeals in Farm Service held only that a non-exempt cooperative may not net patronage losses with nonpatronage gains in calculating its gross income, thereby avoiding taxation at the corporate level of margins attributable to the cooperative's transactions with nonmembers. In the case of exempt cooperatives, however, Section 521 and Section 1382(c) expressly permit deduction of nonpatronage sourced earnings. Congress thus evidenced its intention to permit cooperatives meeting the requirements of these sections to pay only a single tax on such earnings. The Court's reasoning in Farm Service explicitly focused on the distinction between exempt and nonexempt cooperatives, and implicitly recognized the appropriateness of netting patronage losses with nonpatronage margins by exempt cooperatives.

One other point about the Farm Service case is important for our present purposes. None of the Court's reasons for prohibiting netting between patronage and nonpatronage accounts is relevent to the practice of netting among units doing exclusively patronage business. Subchapter T extends single tax treatment to income from a cooperative's patronage business to the extent that such income is paid or allocated to the patrons. When netting occurs between units doing exclusively patronage business there is simply no opportunity for the kind of tax avoidance that the Court identified in Farm Service.

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III. COMMENTS ON SPECIFIC ITEMS

The memorandum to which we respond requested USDA comments on specific items identified in the memorandum. In this section we address those specific items and comment on several other issues as well. We trust that our comments will be of some assistance as the Department of Treasury makes major decisions that will affect the more than 6,800 farmer cooperatives in the United States.

A. Preexisting obligation

The safe harbor memorandum discusses the significance of the preexisting obligation requirement in Subchapter T for netting decision procedures (pp. 1-4 and Appendix A). It concludes that the requirement that refunds must be paid "under an obligation of such organization to pay such amount, which obligation existed before the organization received the amount so paid" governs not only when the obligation to pay or allocate refunds must arise but also exactly how such refunds should be paid. That is, a preexisting legal obligation to pay patronage refunds does not exist if the cooperative members give the board of

directors discretion as to how internal netting will take place at the end of the year.

We outline here our disagreement with that conclusion. We address first the principle of single taxation for cooperative patronage refunds, then the statutory, case and commentary material on the subject.

1. Single Tax Principle and Preexisting Obligation. A survey of tax

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cases, both old and new, of the legislative history of tax laws, and of the statutes and their interpretation, leads us to the conclusion (universally held among cooperative scholars and accountants) that the purpose of the single tax principle is to relieve the cooperative entity of corporate tax on net margins that it cannot, by legally binding obligation, retain for its own use.

On the other hand, if the cooperative is able to retain for its own use, as corporate profit, any net margins, they are subject to corporate taxes. The fundamental purpose of the preexisting legal obligation statement in section 1388 is to eliminate the single tax treatment for any net margins which may be retained as profit by the cooperative.

The straightforward purpose and application of the preexisting legal obligation requirement does not seem to suggest or require--by logic, by extension or by analogy--that internal allocation decisions may not be made after the organization receives the amounts to be paid.

The cooperative, as a taxable entity, is obligated to pay out net margins to users--it cannot keep any. That requirement is the essence of the single tax treatment.

2. Preexisting Obligation Does Not Restrict Internal Allocations. We have carefully considered the information contained in the safe harbor memorandum that is relied upon to show that discretionary allocation fails to meet the preexisting legal obligation rule. The Department disagrees with this position for the reasons given below.

The theory is set forth on page 2 of the safe harbor memorandum that the "deductibility of patronage dividends is based upon the theory that the net

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margins of a cooperative belong to the particular patrons whose transactions produced the net margins, not to the cooperative. This theory applies as long as there exists a contractual obligation of the cooperative to return those margins to those patrons." This theory that net margins are only identified with the specific patron and transaction giving rise to them finds no support in cooperative principles, in the more than 80 State incorporation statutes that describe cooperative operation, in the tax statutes or cases, or in court decisions that define cooperative operations.

We have no difficulty with the statements in the memorandum, particularly in Appendix A where authority is cited, that the preexisting legal obligation is important. (See our previous section.) However, the memorandum cites only one tax court decision as authority for the novel and critical proposition that preexisting legal obligations are separated internally within the cooperative entity. The Dr. P. Phillips case, cited as authority that "this legal obligation must attach to the particular transactions in respect of which the deductible patronage refund is claimed," dealt with a cooperative that had a function to which no obligation existed to make refunds at all. The cooperative could have retained net margins from that function as profits to itself. The Tax Court made no reference whatever to any requirement that cooperatives must be obligated to refund net margins only to those patrons whose transactions gave rise to the net margins.

Based upon this single case and the general rule that the cooperative be obligated, before net margins are received, to return net margins to its patrons, the memorandum concludes that a cooperative may not determine its internal allocation of net margins at the end of the year. We find no sufficient basis for that conclusion.

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3. The Department's Position. The underlying reason for the preexisting legal obligation requirement does not compel further restriction on discretion by the cooperative as to internal allocation. The single tax principle and the preexisting obligation requirement are designed to prevent profit retention by the cooperative, a result not negated in any way by intracooperative allocation and discretionary procedures.

The words of the statute itself make no reference to intermember netting decisions; it requires only that patronage refunds be paid on the basis of "business done with or for such patrons" and that the amount be determined by reference to the net margins of the organization. A further discussion of the statute is presented below in the section on netting. We only note here that a simple rewording of the statute would have made clear any restriction on internal allocation choices, and if the preexisting obligation requirement were as restrictive as suggested in the IRS memorandum, there would be no need for the Subchapter T limitation on unequal or disproportionate payments patrons engaged in substantially identical transactions.

B. End-of-season director discretion

Aside from the implication running throughout the IRS memorandum that netting, in and of itself, is an abuse of the tax laws applied to the cooperative form of business enterprise, the writers seem to be troubled by the discretion granted to the board of directors to make netting decisions during or at the end of the year rather than prior to the time at which net margins are received. The first concern seems to be that the directors themselves make the decision. The second concern, the one most directly related to the preexisting obligation problem, is that the decision is made during or at the end of the year.

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It might be well to point out some reasons that the directors would be given the discretion to make the decision at the end of the year. These justifications, as those outlined earlier for the practice of netting itself, are based upon operational, structural, economic, and control principles that are unrelated to the misuse of the cooperative form of business enterprise for tax avoidance purposes.

Most decisions in cooperatives that concern the payment of patronage refunds, as well as the related decisions that concern the capital structure of the cooperative, are made by the board of directors. The memorandum does not make clear whether the mere fact that directors, rather than the members in a referendum forum, make the decisions is of concern to the IRS. It would appear, however, from the concerns expressed elsewhere in the memorandum about member control, that director-based decisions are in fact a concern.

The principles of the corporate form of business enterprise, the specific statutes under which cooperatives are incorporated, the common law of corporations, and the documents and agreements within the organization itself all assign duties to the board of directors. Boards of directors of a cooperative are required, as they are in any other organization, to act in good faith as they carry out the duties vested in them by the members. They have the highest fiduciary duty toward the members, and may be held accountable by the members for any deviation and abuse of discretion with respect to those duties. We see no justification for artificially separating directors from their own membership for tax purposes.

The members control the cooperative not only through their votes, but through the bylaws. The bylaws further define the parameters of directors'

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discretion to make decisions about the finances and the patronage refunds of the cooperative. Members adopt the bylaws and must approve any changes in them. When the bylaws assign certain discretionary duties to the board of directors, there is no reason to doubt that such provisions express the will of the members or that the bylaws constitute an effective mechanism for cooperative control.

The IRS memorandum presents no evidence, nor are we aware of any, that would indicate that members of cooperatives are unhappy about existing netting practices or that they feel that they lack sufficient power to control netting decisions by cooperative management. We would further emphasize the duties of the members to oversee the affairs of the cooperative. The final decisions, as will be pointed out in our discussion of the memorandum's view of voting, rest with members.

The most serious objection raised in the IRS memorandum with regard to the preexisting legal obligation to return patronage refunds to members appears to be with the timing of the discretionary decision.

We would like to point out a few, but by no means all, reasons that a discretionary decision would not be made before the beginning of the fiscal year.

(1.) One of the central characteristics of farming enterprise is the instability of both production and markets from year to year. The seasonal variations that occur cannot be predicted. It is, in fact, the purpose of the cooperative to respond to these seasonal variations. But a response <u>follows</u> the event.

The results of a seasonal operation are known only at the end of the season. The variations in planting, production, and yield are determined only

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at the end of the season. The financial status of the individual farmers who make up the various units of the cooperative and who have contributed various amounts of product and capital to the cooperative during the season is determined only at the end of the season. Price fluctuations that have occurred during the season because of the variations in supply and demand can be netted only at the end of the season. The performance and the consequences of the pricing practices of a cooperative during the season can be determined only at the end of the season. Market prices (which can only be estimated at the beginning of the year) and the deliveries of the members into various units can only be determined at the end of the year.

End-of-year discretion to make netting decisions permits the cooperative to exercise flexibility in pricing practices during the season in order to participate effectively in markets. For example, where a market associated with one unit collapes, the cooperative may be able to market effectively only by taking a severe loss, but the extent of such a loss may be very difficult to predict at the time when pricing decisions must be made. Knowledge that netting may be available at the end of the year could permit much more competitive pricing methods during the year.

(2.) The ability to make netting decisions at the end of the year is also important to cooperatives that perform a supply function for their members. Unexpected price changes may make a change in allocation units the only fair way to apportion costs. For example, a cooperative may normally have separate allocation units for purchases of heating oil and diesel fuel. In a time of diesel fuel shortages, however, the two fuels may be used interchangeably as diesel tractor fuel. If the cooperative purchased large quantities of heating oil at inflated prices for use by both groups of patrons, it would only be

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fair to combine the two allocation units for the period of the shortage.

(3.) Since decisions on netting depend in part upon predictions for the following years, a requirement that netting decisions be made at the beginning of the year would force cooperatives to base their decisions on even more speculative information than that on which they presently rely. These decisions, which must take into account not only the condition of the cooperative and its members but also that of the industry as a whole, are difficult at best when made at the end of the prior season and quite impossible when made two years in advance of their final effect.

Thus, it is important for the cooperative to leave some of these major decisions as open as possible so that they may be made with as much information available as can be expected from the previous season, and when intelligent forecasts about the coming season, as well as the coming years, can be made.

These are only suggestions of legitimate, nontax reasons that a cooperative would (1) wish to make netting decisions discretionary, (2) assign these decisions to the board of directors, and (3) make these decisions as close to the end of the year as possible. We find that the complicated decisions that rest with farmers themselves about how they run their organization cannot be made by anyone else. The desire to preserve the maximum flexibility for farmers (and for those acting on their behalf) in making netting decisions arises not from a desire to avoid taxation but rather from the need to permit farmers to respond to the volatile natural and economic conditions which so greatly affect the business of agriculture. Such flexibility simply puts cooperatives on an equal footing with other, non-cooperative business entities.

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C. Statement of Potential Abuses

We have previously outlined our concern with the discussion of potential abuses in the IRS memorandum (pp. 4, 5, 6). We note here only a few specific comments to emphasize our dual concern that (1) the memorandum indentifies as tax abuses practices which we believe are entirely consistent with cooperative principles and unrelated to tax avoidance, and (2) to the extent that the memorandum identifies genuine abuses, the rules it proposes are an unnecessarily broad deterrent.

At page 5 in the first full paragraph, the memorandum identifies as an abuse the practice of a cooperative that would run its patronage activities at a loss, knowing that it could earn income from nonpatronage activities. It is our understanding that such a practice cannot now under any circumstances be used to avoid payment of income tax. The Farm Service case explicitly prohibits this practice by non-exempt cooperatives. Exempt cooperatives are entitled to single tax treatment for nonpatronage earnings refunded to patrons. There is no need for further restrictions on cooperative conduct in order to prevent this practice.

We agree that the IRS must continue to exercise oversight over cooperatives to avoid potential abuses of the cooperative form. We do not believe, however, that netting among groups of patrons in a cooperative automatically falls within this class of abuses as characterized on page 6 of the memorandum. Our comments on specific issues discussed in the IRS memorandum follow.

1. Organizational Structure and Abuses - Voting. The IRS memorandum suggests that voting on any basis other than one member, one vote may lead to abuses of the tax status of cooperative enterprise. Comments on voting

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methods are solicited.

Our view is that members themselves should determine the voting method that suits them best, and that a method other than one member, one vote is not a departure from cooperative principles.

We address three topics: 1. Principles upon which voting is based; 2. Authority and use of various voting methods; 3. Cooperative control and perceived abuses.

(1.) Interestingly, a logical extension of the idea of "economic democracy" would suggest voting by patronage rather than on a one member, one vote rule. Economic democracy reflects the business aspects of cooperation.

The purpose of a profit-oriented corporation is to generate benefits for itself. The profit is generated by use of the capital. Profit is returned to stockholders on the basis of their investment contribution to the corporation. The application of economic democratic principles leads to the logical conclusion that the organization should be controlled by those whose participation makes the generation of benefits possible. They should control the organization and receive returns proportionally. That is, the stockholders should vote on a stock basis.

The purpose of a cooperative corporation, on the other hand, is to generate benefits not for itself as an entity, but for its users as patrons, either by direct savings returned to members or by enabling members to generate profits for themselves in their own enterprise. The benefits are generated based on use of the organization. Those benefits are returned on the basis of the use of the cooperative. Application of the economic democracy principle in this case leads to the conclusion that the organization

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should be controlled by those whose participation makes the generation of benefits possible. They should control the organization and receive returns proportionally. That is, the members should vote on a patronage basis.

It would appear then that from the economic and business approach to cooperatives some reason must be found for voting on the one member, one vote basis rather than voting by patronage, not vice versa. The reasons for the one member, one vote rule are historical and philosophical.

Historically, cooperation was not limited to mere business practices--it was not simply a "fourth way of doing business." Cooperation, growing as a reaction to and corrective device for the social and economic evils of the industrial revolution, had social purposes. Cooperation on a grand scale was supposed to alleviate the burden of the victims of industrialization and capitalist-oriented societies. (We suggest a review of the life and ideas of Robert Owen and following social reformers in their quest for cooperative societies.)

There is a "social" as well as an "economic" philosophy of cooperation. Economic democracy flows from the economic philosophy while the one member, one vote idea is part of the "social" philosophy of cooperation. Most cooperatives today contain elements of both philosophies, and there is a balance between fundamental concepts.

The variety of views on cooperative voting as a reflection of cooperative principles is noted by Ward, et al, in Voting Systems in Agricultural Cooperatives where it is stated at page 1:

> In a recent textbook on cooperatives, Martin Abrahamsen stated, "Rochdale principles are accepted by many people as the distinguishing trademark of cooperative business." One of the

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cooperative principles credited to the Rochdale Society, a group of persons who pioneered cooperatives in England in 1844, specifies one member, one vote government of the cooperative. Since then, and particularly in the modern economic system setting, national and international cooperative leaders have debated the relevancy of the one member, one vote principle to cooperatives.
The International Cooperative Alliance's Commission on Cooperative Principles considered the Rochdale principles as they pertain to cooperatives today. The commission stressed the importance of democratic control by members. But the commission also recognized that voting systems may have to be adapted to account for size and complexity of cooperatives and for current economic environment. Thus, the commission recognized importance of one member, one vote governing of cooperatives under certain conditions but acknowledged the possibility--and even desirability--of other voting methods for cooperatives having other conditions.

Contrary to the suggestion that voting on the basis of patronage rather than on a one member, one vote basis may be a way to misuse cooperative enterprise for tax purposes, both methods have their roots in the fundamental principles of cooperative enterprise. The choice between the two must be made by the cooperative members themselves. We are greatly concerned that in an effort to enforce tax laws the Federal government will destroy legitimate variations in cooperative operation.

(2.) The State statutes under which cooperatives incorporate define the methods of voting to be used. In an analysis of State statutes under which farmers can form cooperatives, now being completed by USDA, the provision for member voting power will be addressed specifically.

About 80 statutes are available for use by farmers, some of which are limited to farmer cooperatives, while others are not. Of course, general corporation statutes and other statutes may be used by various cooperatives.

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farm and nonfarm alike.

Our preliminary results show that of the 80 statutes analyzed, a total of 51 limit the voting power of individual members to one vote per member or holder of common stock.

Sixteen of these 51 statutes follow closely the terminology of an act developed in 1919 and adopted by a majority of States. It says, "no member or stockholder shall be entitled to more than one vote, regardless of the number of shares of common stock owned by him." The other 35 statutes in this category use somewhat different terminology to apply the one member, one vote rule to individual members.

Three additional statutes permit the cooperative to limit its vote to one vote per member. Six other statutes say that if voting power is not equal, the method used must be stated in the bylaws.

Voting based on the amount of business done with the association is specifically noted in ten statutes. Two of the ten state that voting power may be based on actual, estimated or potential patronage, or a combination of methods. One statute notes that the relevant patronage measure is that of the previous year. The remaining statutes do not detail plans. In only one statute out of the 80 is there a limit on total voting power of a member if voting is by patronage.

In summary, about 38 percent of the statutes under which farmer cooperatives may incorporate do not limit voting to a one member, one vote principle. Given the use of general corporation statutes and the use of special statutes for certain other nonfarmer cooperatives, it would seem that patronage voting is available for most farmers who wish to use it.

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It should also be noted that major Federal legislation governing agricultural cooperatives, such as the Capper-Volstead Act of 1922 (7 U.S.C. 291, 292), permits voting on other than a one member, one vote basis.

In practice, the one member, one vote rule is the most common approach to voting by farmer cooperatives. The USDA recently conducted a study of voting methods used by cooperatives. The study showed that, in the sample taken, about 72.4 percent of the top 120 cooperatives used a one member, one vote rule, 13.3 percent used proportional (patronage) voting, 7.1 percent used equity voting, and 7.1 percent used some other method.

Though the one member, one vote rule was adopted by the Rochdale pioneers, 28 flannel weavers, in 1844 for their consumer cooperative shop on Toad Lane in London, it is not a universally required or universally adopted rule.

(3.) We have not found that cooperatives that use a patronage voting system are any more susceptible to loss of member control than a cooperative that uses one member, one vote. Neither would we expect a cooperative that uses a patronage system of voting more likely to "use" its cooperative form to abuse the tax laws. (As noted elsewhere we do not agree with the IRS characterization of practices described in the memorandum as "abuses" of the tax laws.) In fact, there may be a number of self-correcting forces at work where patronage voting is established in cooperatives with a disparity of size of membership, the usual situation where patronage voting is found more acceptable than one member, one vote. We, therefore, believe it would a mistake to look with any suspicion upon any cooperative that uses a voting method other than one member, one vote.

2. Allocation of Net Margins. We find the discussion on page 9 of the IRS memorandum called "Allocation of Profits" quite confusing. We would first

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like to correct a misinterpretation of one of our publications, Legal Phases of Farmer Cooperatives, which was interpreted to the effect that a cooperative was required to attribute "profits" to particular patrons in respect to whose patronage the "profits" were earned. Legal Phases states simply that farmer cooperatives differ from other commercial enterprises because, "in a cooperative, the financial benefits flow to the patrons on the basis of their patronage" (p. 357). It nowhere states that patronage refunds must be allocated to a particular patron on the basis of business attributable to that particular patron, as the IRS suggests.

The footnote at page 9 of the IRS safe harbor memorandum notes that under no circumstances may tax deductions be allowed for distribution of net margins if there is no allocation. The text seems to imply that tax abuse would be more likely if the "profits" of some patrons are not allocated to those patrons. This is simply not a problem. Under tax rules too well established to need restatement, no income to the cooperative can escape taxation at the cooperative level if it is not allocated to patrons.

The memorandum requests USDA to indicate whether there are any circumstances under which a cooperative would choose merely to apportion its cooperative "profits" to its members on the books rather than notify the members of the amounts so apportioned. Again, the tax laws are clear that single tax treatment is achieved only if the member is notified in writing of any allocations made to the member. Therefore, such a decision by a cooperative could not result in avoidance of taxation, as the income would be taxed to the cooperative.

The last three sentences of the section on "Allocation of Profits" seem to show a lack of understanding of the basic financing of a cooperative, along

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with its tax consequences. The memorandum assumes that members are able to "cash in" on apportioned or allocated "profits" within a reasonable time after those "profits" are earned. As the tax laws have always recognized, the fundamental basis for allocation (as opposed to cash payment) is that retained patronage refunds are capital contributions to the cooperative. They are not "profits" to be "cashed in." This money is part of the capital structure of the cooperative.

We are particularly concerned that the memorandum offers the protections of the safe harbor only to those cooperatives that redeem all allocated earnings within a fixed period of time. The safe harbor memorandum proposes a redemption period of five years. The Department opposes using a mandatory revolvement period as a tool of tax administration, for the following reasons.

(1.) A 5-year mandatory revolvement period is financially unsound. First, it has the effect of converting equity into debt. This conflicts with cooperatives' needs for permanent capital, reduces their ability to borrow funds and violates other principles of sound financial management. Second, provisional results of an in-house study show that a cooperative could maintain a 5-year revolving plan only by increasing its long term debt, decreasing its growth rate below the average for all cooperatives from 1970-1976, or decreasing the proportion of patronage refunds it pays in cash.

(2.) In 1969 Congress considered and rejected a proposal to require cooperatives to revolve all equities within 15 years. Sec. 531, Tax Reform Act of 1969, HR 13270, as passed by the House of Representatives on August 7, 1969; see also discussion in Legal Phases of Farmer Cooperatives (USDA, 1976)

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at p. 355. We question the wisdom of IRS offering the protections of its safe harbor only to cooperatives that comply with a standard specifically considered and rejected by Congress.

(3.) The standard is inapplicable to cooperatives that do not use a first-in first-out revolving plan. A 1977 USDA study showed that 10 percent of all cooperatives and 27 percent of federated cooperatives that had systematic programs of equity redemption did not use a revolving fund. The two most common alternative plans were (a) the base capital plan, which sets each patron's equity share on a moving average patronage basis over a fairly short period (usually 3 to 5 years), and (b) the percentage of all equities system, which redeems all equities on a declining balance basis, regardless of age. See Equity Redemption Practices of Agricultural Cooperatives, FCS Research Report 41 (USDA, 1977).

(4.) The 5-year redemption period is unreasonably short. Very few cooperatives that use the revolving fund method have such a short revolvement period. The same study cited above showed that the average revolving period for all cooperatives was 10.5 years. Among cooperatives that used the revolving plan in conjunction with other programs, the period was 11.4 years. The safe harbor proposal would make the safe harbor unavailable to the majority of cooperatives.

(5.) Equity redemption practices are currently under study in USDA. In addition, the General Accounting Office has recommended that USDA encourage changes in farmer cooperative equity redemption practices, and if voluntary action is not forthcoming, that USDA consider proposing possible mandatory revolvement or payment of interest on equities. In view of the legislative character of those recommendations, and the ongoing study in-house, USDA thinks it is inappropriate for the safe harbor to include such a requirement.

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We see no prospect for abuse of tax laws through the use of retained net margins. Such net margins that are capital contributions are taxed only once. If retained net margins do not meet the qualifications set out in present cooperative tax statutes, they are taxed to the cooperative at the corporate level and there is no opportunity to avoid paying taxes.

3. "True" Cooperative Ownership. The safe harbor memorandum states (at p. 6) that tax enforcement officials "could not easily avoid the conclusion that the [loss] patrons are the true owners of [a cooperative that consistently nets one department's gain against another's loss] and are simply operating a profitable [gain] operation in the cooperative form." In such a case, the IRS concludes that "it would not be appropriate for tax purposes" for the cooperative to net.

The characterization of the gain patrons as nonowners is unclear. Subchapter T provides single tax treatment for all patronage-sourced earnings refunded to patrons on a patronage basis, whether or not they are members. The IRS seems to imply that earnings from such patrons are really nonpatronage-sourced, and, therefore, netting is prohibited; c.f. Farm Service Cooperative, supra. This conclusion is not supported by any statutory or case authority of which we are aware.

The issue is whether member-owners who patronize different departments can agree to net gains and losses between departments, and this should form the basis of the analysis. As we indicate elsewhere in the paper, we believe that decisions concerning whether and when to net are appropriately those of cooperative members and that they reflect members' conclusions about how their interest can best be served. The decision of a cooperative to net losses

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against gains is not an indication that the members of any particular unit are somehow not "true patrons." 4/

4. Operating on a Cooperative Basis. The memorandum seems to question whether a cooperative that nets, except in a few exceptional cases, is operating on a cooperative basis. It notes that Subchapter T applies to corporations "operating on a cooperative basis" and that tax enforcement officials must therefore exercise oversight to determine "which corporations will qualify for these benefits." The memorandum states that "we believe any wide ranging use of profits belonging to one group of patrons to subsidize the losses of another group must inevitably raise serious questions as to whether the organization is a cooperative."

If a cooperative were to lose its Subchapter T status as a result of its netting practices, it would be taxed as an ordinary corporation. The "subsidization" would continue because corporations can net gains and losses without restriction. The earnings that are apparently escaping taxation would not be taxed in a corporation that nets its gains and losses. However, the patronage refunds (properly deducted because they are paid to the patrons of the gain department) would probably be treated as nondeductible dividends. This would penalize the patrons of the gain department that IRS believed to be exploited already, yet would have no effect on the patrons whose losses were "subsidized."

4/ For a discussion of criteria defining the patronage relationship, see Mississippi Valley Portland Cement, 480 F.2d 827 (5th Cir. 1969).

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It appears incongruous for an organization incorporated as a cooperative under its State's laws, paying patronage refunds to its patrons, operating on a one member, one vote basis, obligated by legally binding documents to return its net margins to its users, prohibited by those same documents from retaining margins for itself as corporate income, and conforming with all generally held cooperative principles, to be labelled a noncooperative by IRS just because it nets patronage gains and losses. To interpret the tax laws so as to disqualify from cooperative status entities that are commonly regarded by experts, by the public, and by their members as cooperatives would serve no useful purpose.

The Tax Code does not contain a definition of a cooperative or of "operating on a cooperative basis." One reasonable conclusion is that Congress was willing to extend the benefits of Subchapter T to those organizations operating under the authority of their State's cooperative statutes or that followed generally accepted cooperative principles. It seems unusual, however, to conclude that Congress, by its silence, granted the IRS power to create criteria not supported by common law, State statutes, Federal law, or generally accepted cooperative principles.

IV. Comments on Safe Harbor Provisions

A. General Comments

The memorandum to which we respond requested comments by USDA on the safe harbor provisions that are outlined and discussed in the memorandum. In this section, we have included our comments on the discussion of safe harbor provisions that begins at page 10 of the IRS memorandum as well as our comments on the rules themselves as outlined in Appendix B.

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At the outset, we should point out again that we disagree with the IRS view that the practices which the safe harbor proposal is designed to limit and control are abuses of the tax laws. In our view, any safe harbor proposal must be directly related to an abuse of tax laws; that is, application of a safe harbor requirement must prevent a tax abuse. In addition, any such proposal should be designed so as to minimize its impact on a cooperative's structure and functions which are not tax related. Our comments on specific aspects of the IRS safe harbor proposal are made in light of these general principles.

B. Analysis of Specific Provisions

1. One member, one vote. The desirability of a one member, one vote rule is noted as item IV of Appendix B and again on page 10. The memorandum states "[as] a general rule, voting in the cooperative must be done on a 'one member, one vote' basis, although the Service [IRS] is willing to recognize exceptions to the rule if no one member can exercise directly or indirectly more than 5 percent of the total vote."

As we pointed out earlier, use of a voting method other than one member, one vote is not an abuse of the tax laws. Voting methods of a cooperative are the means by which the members control the organization. We have noted the variety of voting methods permitted and used by cooperatives. We have also noted our view that the voting methods used are not related to perceived abuses of the tax law as suggested in an early part of the IRS memorandum. If a cooperative engages in a course of conduct which is held to be an abuse of the tax laws, it is of little relevance how the members voted to so proceed. No one method of voting is more or less likely to lead to tax abuse than any other method.

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Restrictions on how cooperative members will control their cooperative strike at the heart of the idea of cooperation itself. We have pointed out the numerous reasons why cooperative members may not wish to adhere to the one member, one vote rule. We believe it would be impossible to scrutinize the motivations of the members and find a tax related reason for the voting procedures. Although most cooperatives, according to our studies, do use the one member, one vote rule, a restriction on voting methods would have far-reaching effects on a significant number of cooperatives. Those that deviate from the one member, one vote rule believe they have good reasons to do so. In our view, no tax-related justification exists for a restriction on permissible methods of voting by members of cooperatives.

2. Unit Voting. The safe harbor provisions on page 15 of the IRS memorandum under I.B. would require that "[a] majority of the members of each group that comprises a given allocation unit votes every two years to have the result of its transactions combined with the result of the other groups within the unit." (Emphasis in original.)

As with the one member, one vote provision, there is no abuse of the tax laws inherent in the voting procedures of the various members of the organization. Likewise, we find little evidence that there is a relationship between the abuse of tax laws and combined voting by groups within an organization.

As we have noted previously, one of the essential features of a cooperative is that the organization is operated for the mutual benefit of all members. There is an essential link among all members, whether they participate in the same function or different ones. The vote of the entire

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membership, just as the vote of all citizens of the United States, determines the policies of the organization. This is the essence of democratic control. We believe that the consequences of the voting method designed to offer a safe harbor would be divisive. It would impose a considerable burden on every cooperative. The results of the application of such an unusual and invasive regulation would be extremely counterproductive.

3. Member Information. Several provisions in the safe harbor proposal refer to the information made available to the members. We agree that the more information made available to the members the better. While we are not convinced that is the mandate of a tax collection agency to so enforce desirable principles of operation upon a coopertative, we have no objection to such information exchange.

Many of the concerns expressed in the memorandum over potential tax abuses may, in fact, be alleviated by notification to patrons that the refunds they received were the result of netting separate net margins and losses to arrive at a final refund. Perhaps a written notice of this fact, either accompanying the written notice of allocation or accompanying the cash refund itself, would be helpful to members.

4. Interfunctional Netting. Item III of the safe harbor proposal (p. 17) would bar netting between marketing and purchasing functions of a cooperative. It would not appear to us to be an abuse of the tax laws to net across marketing and purchasing functions simply because they are so different. As we have outlined in the example presented in this document and in our discussion in the 1978 USDA paper on cooperative interunit netting, we question the adverse tax policy consequences of such interfunctional netting.

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We would also note that in some cases the two functions complement each other. Examples are numerous where an operation to supply feed to a group of members also facilities the marketing of grain for a different group of members. No aspect of the decision-making process on netting, discussed in our introductory material in this paper, would justify a blanket prohibition on interfunctional netting.

In a very recent case, the Tax Court rejected the IRS position that a cooperative may not net across functional lines. In Ford-Iroquois FS, Inc., 74 T.C. No. 88, (Sept. 9, 1980), the cooperative had netted patronage losses during 1971 and 1972 from its grain department against 1973 department income. The court stated:

> Here petitioner is applying grain patronage losses against farm supply patronage income where there is a substantial overlap of member business between the two operations, and where the members themselves appear to find such an allocation fair. We find no impediment in the statute or the regulations to this action.

A blanket prohibition on netting across functional lines would cause a hardship to a number of cooperatives. This is true not only where one function, such as a supply function, is a minor part of the overall organization, but also where both functions are of major importance to the organization and the membership is substantially the same for each. It is our understanding that many cooperatives net across functions as a matter of course.

5. Interunit Netting. The memorandum is somewhat unclear as to the circumstances under which netting generally would and would not be permitted. We have discussed the netting issue in some detail and concluded that netting

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is not a means to abuse tax laws. In our view, interunit netting of margins attributable to patronage business should be permitted under the tax laws as they now apply to cooperatives.

Item II.B. of the safe harbor provision in Appendix B also outlines restrictions on the treatment of losses by units of a cooperative. We have discussed this problem in some detail in this reply and in the previous USDA memorandum on Cooperative Interunit Netting. We believe that many of our arguments with respect to interunit netting apply to the treatment of losses as well. As we pointed out, ordinary treatment of losses by units of cooperatives is consistent with the economic interests of the members of the cooperative and with the requirements of the tax laws. A requirement that a unit's losses be currently recouped would interfere with the internal decision-making of the cooperative with no consequent benefit to the tax system.

6. Netting Discretion. Several of the safe harbor rules are directed to prevent any flexibility during the year in the netting decision. Item I.A. of Appendix B, for example, would require that "the cooperative's articles of incorporation, bylaws, or marketing or purchasing agreements specifically detail the composition of all allocation units and how earnings and losses are to be allocated within each allocation unit." Item II.A. on page 17 states that "the net earnings or losses of an allocation unit must be allocated to the patrons of that unit pursuant to a preexisting legal obligation and not in a manner dependent upon a discretionary decision of the board of directors of the cooperative."

As we have discussed at some length, flexibility in the netting decision of a cooperative is not by itself an abuse. The decision on netting is not

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related to taxation. If there are tax consequences of certain netting decisions, (e.g., the consequences of netting patronage and nonpatronage accounts as discussed by the court in Farm Service), those consequences can be specifically addressed. The IRS has presented no evidence to justify rules that would strictly control the decision-making process of cooperatives with respect to netting.

We have outlined previously some of the numerous reasons cooperative members might wish to assign their board of directors the power to make netting decisions after the beginning of the year. To prevent exercise of this discretion by the board of directors would cause considerable harm to many cooperatives.

We have previously discussed our concern that the preexisting legal obligation requirement of Section 1388(a) is misapplied in the IRS memorandum with respect to discretion exercised by cooperatives' boards of directors.

7. Allocation. As noted previously, we are somewhat confused by the safe harbor requirement that a cooperative must allocate all net earnings to the patrons. Item V of Appendix B states that "all net earnings of the cooperative must be allocated (through patronage dividends or qualified or nonqualified written notices of allocation) to the patrons to whom they belong rather than merely apportioned on the books of the cooperative."

Single tax treatment is available only when net margins are so allocated. Where net earnings are not allocated, as where they are placed in unallocated reserves, the double tax applies. Failure to allocate all margins to patrons thus has no tax impact.

V. Conclusion

We have carefully considered the safe harbor memorandum, and we appreciate the difficulties attendant on tax law enforcement. We must conclude, however, that the views on enforcement policies suggested in the memorandum are not in keeping with cooperative principles as commonly understood and applied.

We believe that interunit netting is not an abuse of the tax laws. It is instead a necessary management option that enables cooperatives to deal successfully with the sometimes uncertain economic environment in which American agriculture operates.

Netting is not a recent innovation. We are not aware of any trends in netting in the cooperative community. We believe that netting is as common today, and as accepted by cooperative scholars, advisors, and members, as it was in 1951 and 1962.

We find no evidence that Congress intended to exclude from cooperative tax treatment organizations that satisfy generally accepted cooperative principles, that meet the requirements of State cooperative incorporation statutes and Federal statutes defining cooperatives (e.g., the Capper-Volstead Act of 1922 and the Agricultural Marketing Act of 1929), or that historically and commonly have operated as bona fide farmer cooperatives.

We believe that a departure from existing tax rules which would disqualify cooperatives recognized as bona fide cooperatives for all other legislative, judicial, and operational purposes must be scrutinized carefully. The proposed rules to which we have responded are such departures. We believe them to be unnecessary and burdensome to cooperatives that engage in a variety of netting, voting, and other practices for legitimate, nontax-motivated reasons.

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Senator CHAFFEE. Senator Nunn, we are glad to have you with us, and we look forward to hearing your statement.

STATEMENT OF HON. SAM NUNN, A U.S. SENATOR FROM THE STATE OF GEORGIA

Senator NUNN. Thank you, Mr. Chairman. I am pleased to join Senator Mattingly, and I strongly support his legislation which I have cosponsored. I would refer to the National Council of Farmer Cooperatives' testimony. I assume they will be giving their testimony later on this morning, but it is a very thorough portrayal of both the background and the court decisions in this area. And I strongly support the thorough brief that they have submitted here. Since the passage of the Revenue Act of 1951, which contained provisions regarding the taxation of farmer-owned cooperatives, netting of profits and losses from different services provided by a cooperative has been a standard practice of most diversified cooperatives. This practice is similar to a farmer who totals his profits and losses from production of different commodities before calculating his net earnings and taxable income. Netting is absolutely essential to the ability of farmer cooperatives to survive in today's volatile farm economy. The fundamental purpose of cooperatives is to pool resources and share the risk of loss and would be fundamentally altered if cooperatives were not allowed to utilize netting. Mr. Chairman, in our part of the country, the farmers who, over the last 20 or 25 years, have not specialized, many of them have gone completely broke. Some, of course, that have diversified have gone broke, but the diversity in agriculture in the Southeast United States has been absolutely essential to survivability. I can speak to that from personal experience. I have been a member of a cooperative for many years, and my father before me; and most farmers in the State of Georgia have been. One of the reasons the cooperatives were formed was that, during the Depression, they wanted to spread the risk. Not only to spread the risk in terms of, let's say, cotton farmers and pooling resources in that area, but having cotton and pecans and peanuts and tobacco and other commodities offset risks of having all of the eggs in one basket. That was the purpose, for instance, of Gold Kist when they formed in the 1930's. So, if you take away netting, it is not just a tax question; it is a question of whether cooperatives can survive, and it alters fundamentally the basic precepts of sound agricultural practices in our region. So, speaking from personal experience, I think it would be an absolute disaster if the Internal Revenue Service is allowed to prevail on this. They have got somebody, I guess, with a visor and eyeshades that sits over there and looks at this in a theoretical fashion, and there may be some legalistic argument they make. But from a practical point of view, this is contrary to the intent of the original law. It is contrary to the intent of the formation of the cooperatives. It is contrary to the intent of the court decisions. It is contrary to the intent of Congress. It is contrary to everything about the background of this act. It is really not understandable to me how the Internal Revenue Service continues to move in this direction. Each time the cooperatives have felt that they have convinced the IRS and the people up above, somebody has come in

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later on—a year or two later—and renewed the whole issue again. So, I hope we can put it to rest. It seems to me the law itself is absolutely clear; but if the law is not clear, and it must not be clear enough for the Internal Revenue Service, then I think we have a duty in Congress to set it straight once and for all. It we are not allowed to have diversity in cooperatives, and the no netting rule would preclude that, then in my opinion cooperatives cannot continue to exist in a vital way. People may argue one way or the other on cooperatives, but I think if you look at the history of agriculture in our part of the country—and I believe it is true in many other parts of the country—without cooperatives, the state we are in today would be even worse. So, Mr. Chairman, I appreciate your having this hearing. I know you have many important matters. I would ask that the balance of my statement be put in the record, but I think that it is enormously important that this matter be straightened out at the earliest possible opportunity.

Senator CHAFEE. Thank you very much, Senator.

[The prepared written statement of Senator Nunn follows:]

STATEMENT OF SENATOR SAM NUNN
Subcommittee on Taxation and Debt Management
July 15, 1985

I would like to thank Chairman Chafee for conducting this hearing today on the issue of netting of losses and gains by farmer cooperatives. This issue is of vital importance to the future of American agriculture and the thousands of farm families who are members of farmer cooperatives. I appreciate the opportunity to testify today in their behalf.

Mr. Chairman, I strongly support the position of the National Council of Farmer Cooperatives that the netting of profits and losses among the various departments of a farmer cooperative is proper and intended by the Internal Revenue Code. Since the passage of the Revenue Act of 1951, which contained provisions regarding the taxation of farmer-owned cooperatives, netting of profits and losses from different services provided by a cooperative has been a standard practice of most diversified cooperatives. This practice is similar to a farmer who totals his profits and losses from the production of different commodities before calculating his net earnings and taxable income. Netting is essential to the ability of farmer cooperatives to survive in today's volatile farm economy. The fundamental purpose of cooperatives, to pool resources and share the risk of loss, would be altered if cooperatives were not allowed to utilize netting.

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Since the mid-1960's the IRS has questioned the practice of netting. For fifteen years, since 1970, the IRS Manual has stated that the question of whether a cooperative can net profits and losses between departments has been under study. This uncertainty has existed even though several court cases have been litigated on this subject and the court decisions have clearly stated that cooperatives do have the right to net under current tax laws. Despite these court rulings, and what I believe is the clear Congressional intent that cooperatives should be allowed to net, the IRS has continued to pursue an ill-advised notion against netting.

Earlier this year, the Internal Revenue Service issued a technical advice memorandum against netting. Since that time, Senator Mattingly and I and over thirty of our colleagues have attempted to show the IRS and the Treasury Department the error of their ways on this issue. Secretary of Agriculture John Block has also opposed the IRS action and has requested Secretary Baker to review this matter in the hope that corrective action would be taken by the Treasury Department. The Department of Agriculture recognizes the critical importance of netting to the existence of farmer cooperatives.

Mr. Chairman, despite our efforts to address this problem administratively, it appears that it will be necessary for Congress to reconfirm that farmer cooperatives should be allowed to net. I believe this hearing will indicate the validity of the cooperatives arguments and the fallacy of the IRS position.

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I will not take any more of the Subcommittee's time at this point. Representatives of the National Council of Farmer Cooperatives will present in detail the views of the agricultural community on this important subject. Let me just reiterate my agreement with the position of the Council. I urge the Finance Committee to find a legislative vehicle at the earliest opportunity on which an amendment can be added which will clearly state that netting is approved. Mr. Chairman, I appreciate this opportunity to appear before you today. I would also ask that a statement by Senator Heflin which I will provide be included in the hearing record.

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Senator CHAFEE. I have a couple of questions here. First, both of you gentlemen are from Georgia. Senator Thurmond is from South Carolina. Is this something that is rather peculiar to Southeast United States? Are they stronger there, or is this a matter that impacts you more than other areas? Is there something to that, or is it these co-ops nationally?

Senator MATTINGLY. No, I think it is a national problem.

Senator NUNN. I would say I would agree that it is a national matter, but some of the big cooperatives in our area have for years and years had the policy of diversification, and they have distributed patronage refunds on that basis. And if this is applied to them retroactively, which is what the IRS is saying, then they are out of business. It is not going to be any simple inconvenience because the cumulative total of tax liabilities over the years would just put them completely out of business. So, to that extent, it may be more damaging in our part than in other parts, although each cooperative would be individual and it would be based on practices. But there is no way they can go back and correct this kind of retroactive legislating in my view by the IRS because, for one thing, certain divisions have been dismantled. They have had various parts of their overall operation that have completely gone out of business because they weren't able to ever make a profit in them. And in those divisions, there would be no way you could go back and recoup anything there. The other thing is that patronage dividends that have been paid out on a netting basis could not be recouped. And the other provision is, in a period of great agricultural stress, if they all of a sudden had to pay taxes on individual operations retroactively over 20 to 25 years, and then have carryover losses that would have offset those if you didn't have a netting rule, then those carryover losses could only be recouped against earnings in the future. And, frankly, for the next 5 years it doesn't look to me like you are going to have any earnings. They will be lucky to survive under the agricultural climate we have today. So, those losses would virtually be of no use; and even if a 20 year prospect looked like they could use them, you couldn't survive in the short run. So, this is a matter of short-term survival for some of our cooperatives, and on others it is a matter of preventing the kind of diversification that I think sound agricultural practices in some sections absolutely requires.

Senator CHAFEE. As both of you gentlemen know, we are spending a lot of time on this committee and in the Senate as a whole and the Congress as a whole talking about deficit spending and tax reform. Senator Mattingly, suppose we made this prospective and wiped out and forgot the past, and the IRS should prevail prospectively? What is your view on this on the harm to the co-ops?

Senator MATTINGLY. First, I think what you need to be looking at is whether netting is allowed or should it not be allowed. You know, the netting issue is something that even General Motors uses between Chevrolet and Pontiac and their other divisions. So, it is really just a decision to clarify the law that has already been tried three times in the tax courts and in the eighth circuit, which have ruled that netting is legal. It is just that there has been a debate within the IRS itself. So, I think what needs to be clarified

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is not whether it be prospective or not, but whether the law should be reaffirmed as it has already been interpreted by the tax courts.

Senator CHAFEE. I certainly have the feeling that, as both of you gentlemen have stated, farmers are in a lot of trouble, anyway, and I am not sure this is the time to put any more burdens on them.

Senator MATTINGLY. Right. Let me add one other thing. I think the IRS may come forth and say that your question may have been directed at whether there could be any loss of revenue. There is no revenue loss in this.

Senator CHAFEE. Since it is not happening already anyway?

Senator MATTINGLY. That is correct.

Senator CHAFEE. All right. Are there any other points you want to make, gentlemen?

Senator NUNN. I was just going to say that, even prospectively, it to me would be basically unfair as Senator Mattingly has said because if you have—let's say you have six different commodities being handled by a big cooperative, and the peanut division makes a profit and the cotton division loses money. Then you are basically saying you can't take the profit and offset it with the cotton losses. What you are saying then is that the only way those cotton losses can ever be recouped is, if at some point in the next few years, that division makes a profit. Now, if that division isn't going to make a profit and it looks like they are not going to make it, that division is going to have to go out of business because, unless you can take those losses and offset those gains over here, the co-op has no alternative except to just cut it off. Now, sometimes they have to do that anyway, but I don't think the IRS should preclude business decisions; and certainly in a period of agricultural downturn which we are in now, they should not be in a position of forcing the only help that some farmers have in terms of cooperative effort to go out of business because they can't utilize those losses against profits elsewhere. This is not a tax flimflam or any kind of, it seems to me, loophole or any kind of abuse at all. It is just simply a question of how much net profit that an individual entity made in a year, and they are perfectly willing to pay taxes on that.

Senator CHAFEE. I think one of the arguments from IRS is that when the farmer comes in with, say, he is strictly a cotton farmer, and he deals with the cotton side of the co-op, that his risk is limited to the cotton side. Yet, he is becoming the beneficiary of an organization that is stronger than just the cotton.

Senator NUNN. Is that a business decision for cooperatives, or should the IRS be making that business decision? I mean, it seems to me that IRS has the duty to make tax policy but not to use tax policy to force business decisions, and that pecan farmer who comes in knows what the rules are and what the flexibility is. And he knows what the board of directors has done in the past, and he elects the board of directors. So, it seems to me the IRS, under that argument, is basically using tax policy to try to have an equity kind of decision in their eyes that is basically a business decision, not a tax decision.

Senator MATTINGLY. I would say that that is actually what your question is. That is the purpose of the cooperative also. And that is also what subchapter (t) already permits. That is what the Federal Tax Courts have already decided in each and every case that comes

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before it in reference to netting. So, it has been confirmed by all those actions taken previously.

Senator NUNN. That argument by IRS basically says that they don't like risk sharing. They don't like spreading the risk as widely, and they want to make it a much narrower sharing of risk. They want cotton farmers to stand on their own, pecan farmers, peanuts, tobacco; and I think that goes to the heart of what sound business people in agriculture for years have felt was the necessity for diversification, to hedge against calamity in one commodity or the other in one year. And we have had it time after time.

Senator CHAFEE. All right, gentlemen. Thank you very much. We appreciate your coming. You make a convincing case.

Senator MATTINGLY. Thank you very much. I have another statement from Senator Abdnor for the record and also Senator Kasten, and I would ask for you to leave the record open so that we can put the rest of them in.

[The prepared written statements of Senators Abdnor and Kasten follow:]

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Statement of Senator James Abdnor
Before the Committee on Finance
July 15, 1985
Agricultural Cooperative Taxation

Mr. Chairman and distinguished members of the committee: I appreciate having this opportunity to share my views on a subject of serious importance to me, agricultural cooperatives in South Dakota and across the nation, and the farmers and ranchers which cooperatives serve.

It is my hope that the Finance Committee will take action to stop the Internal Revenue Service's (IRS) unfair attack on agricultural cooperatives. It is my hope that the Finance Committee's action will clarify the right of agricultural cooperatives to net gains and losses in determining taxable income.

Let me point out that agricultural cooperatives are the backbone of economic activity in rural America. These farmer-owned cooperatives provide a host of services to their farmer-members. Producer-owned cooperatives have contributed greatly to agricultural efficiency, farmer education, farm and ranch mechanization, successful marketing and processing of agricultural commodities, and technological research in the field of agriculture.

Unfortunately, the Internal Revenue Service (IRS) has attempted to deny farmer-owned agricultural cooperatives the right to offset losses in one area of business activity against gains from other areas of activity. This practice -- referred to as netting -- is allowed routinely for all other proprietary business enterprises. However, in 1965, the IRS started to question the right of cooperatives to net gains and losses.

Again in January of this year, IRS issued a ruling holding that cooperatives may not net gains and losses.

Let me point out to my colleagues that IRS is attempting to discriminate against agricultural cooperatives. Cooperatives are not asking for special treatment; they are asking only for fair treatment. Every other proprietary business enterprise is allowed to net gains and losses. Any other business can offset losses in one area of that business's activity against gains in another area. It is my hope that action will be taken to reaffirm the right of farmer-owned cooperatives to do this very same thing.

If a private businessman who owns a hardware and appliance store loses money selling hardware but makes money selling appliances, he can offset the losses against the gains or "net" his income. Conversely, IRS is attempting to prohibit agricultural

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cooperatives from "netting" their incomes. If IRS had its way, a feed and fertilizer cooperative which lost money selling feed but yet made money selling fertilizer would not be about to offset the losses against the gains. Clearly, this isn't fair, right, or equitable. In my opinion, it is an attempt by IRS to undermine the co-op system.

This issue has been litigated on three different occasions, and in each instance Tax Court rulings against IRS clearly reaffirmed the right of agricultural cooperatives to net gains and losses among their various divisions.

In each occasion the Tax Court ruled strongly in favor of agricultural cooperatives. In the case of the Associated Milk Producers, Inc. v. the Commissioner of Internal Revenue, the Tax Court forcefully held the following:

> "We consider (the Commissioner's) position herein not only contrary to the express provisions of section 172, but conceptually strained and lacking any fundamental policy support; in short, an unwarranted tinkering with the tax structure applicable to cooperatives."

Mr. Chairman, it is clear to the courts that agricultural cooperatives have the right to net gains and losses. IRS is waging an unwarranted, and, according to the courts, illegal attack on farmer-owned cooperatives. I thank you and the otherdistinguished members of the Finance Committee for agreeing to examine IRS's attack on cooperatives and I pledge my total support for legislation which would reaffirm the right of cooperatives to net gains and losses.

STATEMENT BY

THE HONORABLE ROBERT W. KASTEN, JR.

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

SENATE COMMITTEE ON FINANCE

JULY 15, 1985

MR. CHAIRMAN, I APPRECIATE THE OPPORTUNITY YOU HAVE GRACIOUSLY PROVIDED FOR ME TO EXPRESS MY CONCERN ABOUT THE ISSUE THE SUBCOMMITTEE IS DISCUSSING TODAY. I WISH TO STATE IN THE MOST FORCEFUL TERMS MY VIEW THAT ACRICULTURAL COOPERATIVES SHOULD CONTINUE TO BE PERMITTED TO "NET" THE CAINS AND LOSSES THEY DERIVE FROM THEIR VARIOUS DEPARTMENTS AND FUNCTIONS FOR THE PURPOSE OF DETERMININC THEIR TAXABLE INCOME.

IN TRUTH, MR. CHAIRMAN, I AM DISAPPOINTED THAT THE SUB-COMMITTEE NEEDS TO CONSIDER THIS ISSUE AT ALL. "NETTINC" IS A LONC-USED PRACTICE, CLEARLY CONSISTENT WITH THE LAWS PERMITTING THE ESTABLISHMENT OF ACRICULTURAL COOPERATIVES. TO MY KNOWLEDGE, CONCRESS HAS NEVER SEEN FIT TO CHALLENCE IT.

MOREOVER, THE UNITED STATES TAX COURT HAS DECISIVELY RULED ON THREE OCCASIONS THAT COOPERATIVES HAS THE RICHT TO NET CAINS AND LOSSES. IN ADDITION, SECRETARY OF ACRICUL-TURE JOHN BLOCK HAS REITERATED HIS DEPARTMENT'S SUPPORT OF THIS PRACTICE.

DESPITE THESE FACTS, THE INTERNAL REVENUE SERVICE HAS

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ISSUED A TECHNICAL ADVICE MEMORANDUM, DATED JANUARY 25, 1985, HOLDING THAT COOPERATIVES DO NOT HAVE THE RIGHT TO NET GAINS AND LOSSES. THIS RULING, ASTOUNDING IN VIEW OF THE PAST HISTORY OF THIS ISSUE, WOULD EFFECTIVELY FORCE COOPERATIVES TO OPERATE EACH OF THEIR ACTIVITIES AS SEPARATE BUSINESSES. THE RULING WOULD MEAN THAT A COOPERATIVE ENGAGED IN MORE THAN ONE BUSINESS ACTIVITY WOULD HAVE TO OPERATE EACH SEPARATELY FOR TAX PURPOSES.

OTHER TYPES OF BUSINESSES ARE PERMITTED TO OFFSET PROFITS IN ONE LINE OF BUSINESS AGAINST LOSSES INCURRED IN ANOTHER. THERE IS NO GOOD REASON WHY COOPERATIVES SHOULD NOT ALSO BE ALLOWED TO DO THIS. INDEED, AS SECRETARY BLOCK AS STATED, "IRS' DETERMINATION IMPUTES VALUES AND PRINCIPLES TO THE INTERNAL COST ACCOUNTING METHODS OF COOPERATIVES THAT APPEAR TO BE INAPPROPRIATE UNDER THE LAWS GOVERNING COOPERATIVES."

THIS AREA OF THE TAX CODE REQUIRES NO CHANGE. IN VIEW OF THE IRS' OBSTINANCE ON THE ISSUE OF NETTING, HOWEVER, I THINK IT APPROPRIATE TO AMEND SECTION 521 AND SECTION 1388 OF THE INTERNAL REVENUE CODE TO MAKE CLEAR THAT COOPERATIVES MAY NET GAINS AND LOSSES.

MR. CHAIRMAN, THE PRACTICE OF NETTING IS ESSENTIAL IF AGRICULTURAL COOPERATIVES ARE TO BE ABLE TO MANAGE RISK EFFECTIVELY. I URGE THE SUBCOMMITTEE TO ACT TO ENSURE THAT THIS PRACTICE WILL CONTINUE TO BE AVAILABLE TO OUR FARMER-OWNED COOPERATIVES.

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Senator CHAFEE. All right. Thank you both for coming. Senator Thurmond is not here, so we will proceed with Mr. Mentz from the Treasury Department. Why don't you proceed? Now, wait a minute, we have a statement from you. Oh, yes, I have it. All right. Why don't you proceed, Mr. Mentz?

STATEMENT OF J. ROGER MENTZ, DEPUTY ASSISTANT SECRETARY FOR TAX POLICY, DEPARTMENT OF THE TREASURY, WASHINGTON, DC

Mr. MENTZ. Good morning, Mr. Chairman. It is a pleasure to be here to represent the Treasury Department. Mr. Pearlman, the Assistant Secretary, is out of the country and could not be here today, so I am representing the Treasury in his place. As you know, this hearing is in response to the floor amendment to the supplemental appropriations bill that directed the Treasury Department to study cooperative netting issues. We are in the process of conducting that study, Mr. Chairman, and I would be glad to share with you today some of the issues and some of the tax policy considerations that we have identified. We have not completed the study. We are working with the Department of Agriculture, and we have input from the industry as well. I would like to say at the outset that it is very much my view that this matter can be worked out administratively; and while our study is not complete, and as you will hear in a minute, there are some difficult and interesting tax policy considerations, I think that we can work them out satisfactorily without resort to legislation. What we have here is a special set of tax rules that are designed to accommodate uniquely situated taxpayers. As with any set of unique or different rules, there is sometimes tension put on the rules. Taxpayers test the limit of how far those rules are intended to go, and resolving that tension requires careful balancing. It is that kind of balancing that the Treasury Department is now engaged in. I want to say to you that, before this week, I had never done any work on farm cooperatives. So, I certainly come to this with a totally open mind, Senator.

Senator CHAFEE. I think that it is an arcane area that not everybody is deeply involved in.

Mr. MENTZ. That is for sure. The tension that we have is the difference between taxation of cooperatives and taxation of corporations generally. And you, of course, are well familiar with the two-tier system of taxation that we have between corporations and individual shareholders, where you have ordinary profits taxed to the corporation and then taxed again when distributed as dividends to the shareholders. Now, the taxation of cooperatives—and I might say that farm cooperatives are not the only kind of cooperatives; there are other forms of cooperatives—but we are talking mostly this morning about farm co-ops. They are subject to a different regime of taxation that can result in only one level of taxation. And just outlining it very briefly, a farm cooperative is a vehicle through which farmers can combine to benefit from efficiencies of scale, increased market power, and enhanced capital formation opportunities. They can band together and sell their produce to the cooperative, which then goes and markets the products; or going

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the other way, they can get together and use the cooperative as a purchasing vehicle to acquire——

Senator CHAFEE. Excuse me, Mr. Mentz. What we are going to do right here—if you could just step back and let Senator Thurmond, who is extremely busy, come forward—we will let you pick up right where you are. You won't miss a beat.

Mr. MENTZ. All right.

Senator CHAFEE. That would be fine. Senator Thurmond, we welcome you. I know you have a busy schedule, and we look forward to hearing your remarks.

STATEMENT OF HON. STROM THURMOND, A U.S. SENATOR FROM THE STATE OF SOUTH CAROLINA

Senator THURMOND. Mr. Chairman, that is very gracious of you, as you are always gracious, and I appreciate your courtesy. I am very pleased to be here. I want to thank you and the other members of the Senate Finance Committee and the Subcommittee on Taxation and Debt Management for holding this hearing on the important issue of farm cooperative taxation. Farmer cooperatives are a critical component of the agriculture industry of this nation. Through these cooperatives, farmers work together in a concerted effort to market their goods more effectively. The ability to effectively market agricultural commodities and products is especially important during the difficult economic times farmers are currently facing. Mr. Chairman, over the last 20 years, the Internal Revenue Service has tried again and again to prevent agriculture cooperatives from netting gains and losses of their various cooperative divisions. For other similar business entities, netting gains and losses between divisions is a normal business practice, unchallenged by the IRS. Not allowing farm cooperatives to net their gains and losses restricts their growth and prevents them from competing effectively in the existing difficult agricultural climate. This situation could lead to a dismantling of this important component of the economic structure of our agricultural industry, possibly endangering the long-term future of farming in this country. The Tax Court has repeatedly ruled against the IRS on this issue, but nevertheless, IRS officials continue to bring these futile cases. This is a waste of both the taxpayers' and the farmers' time and money. We need to clarify this issue once and for all so that agricultural cooperatives may get on with the business of marketing their products without further interference from the IRS. I urge the members of this committee to act expeditiously to resolve this matter. Mr. Chairman, again I want to thank you for your kindness and consideration

Senator CHAFEE. Thank you very much, Senator Thurmond. As you know, Senator Mattingly and Senator Nunn are deeply involved in this, and they testified before. Your testimony is a further evidence of the deep concern that you all have in this matter, and we certainly will give it rapid consideration.

Senator THURMOND. Thank you very much.

Senator CHAFEE. Thank you for coming.

[The prepared written statement of Senator Thurmond follows:]

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STATEMENT BY SENATOR THURMOND (R-S.C.) BEFORE THE SENATE FINANCE SUBCOMMITTEE ON ENERGY AND AGRICULTURAL TAXATION REFERENCE TAXATION OF FARMER COOPERATIVES, ROOM 215, DIRKSEN SENATE OFFICE BUILDING, MONDAY, JULY 15, 1985, 9:30 A.M.

MR. CHAIRMAN:

I would like to thank you and the other members of the Senate Finance Subcommittee on Energy and Agricultural Taxation for holding this hearing on the important issue of farm cooperative taxation.

Farmer cooperatives are a critical component of the agricultural industry in this Nation. Through these cooperatives, farmers work together in a concerted effort to market their goods more effectively. The ability to effectively market agricultural commodities and products is especially important during the difficult economic times farmers are currently facing.

Mr. Chairman, over the last 20 years, the Internal Revenue Service (IRS) has tried again and again to prevent agricultural cooperatives from "netting" gains and losses of their various cooperative divisions. For other similar business entities, netting gains and losses between divisions is a normal business practice, unchallenged by the IRS. Not allowing farm cooperatives to net their gains and losses restricts their growth and prevents them from competing effectively in the existing difficult agricultural climate. This situation could lead to a dismantling of this important component of the economic structure of our agricultural industry, possibly endangering the long-term future of farming in this Country.

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The Tax Court has repeatedly ruled against the IRS on this issue. Nevertheless, IRS officials continue to bring these futile cases. This is a waste of both the taxpayers' and the farmers' time and money.

We need to clarify this issue once and for all so that agricultural cooperatives may get on with the business of marketing their products without further interference from the IRS. I urge the members of this Committee to act expeditiously to resolve this matter.

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Senator CHAFEE. All right. Mr. Mentz, why don't you just slide over once again and continue you statement?

Mr. MENTZ. All right. As you said, not missing a beat, here we go. I was just getting into the basic concept of cooperative taxation. And I think it is easy to understand if you look at a cooperative that only deals in one product. I realize that is not the issue before us, but to understand how it is different from the general corporate taxation model, it is useful to consider a cooperative that only deals in wheat, for example. Farmers gather their wheat; they sell the wheat to the cooperative. The cooperative then markets the wheat, and if it makes a profit on the wheat and is obligated, either through its bylaws or through other mechanism that create a legal obligation, to rebate the profit to the producers, to the farmers, it gets a deduction for that—what is called a patronage dividend—a refund of the profit to the patrons. As a result of that patronage dividend, there is no taxation—no corporate taxation—to that cooperative. There is no tax because of the deduction: not because the general corporate tax doesn't apply, but because the patronage dividend is deductible, and therefore there is no net income to be taxed. That is the way that a cooperative works, and that is the way that two-tier taxation of income earned by cooperatives is avoided.

Senator CHAFEE. Now, suppose the market fell precipitously and the co-op had a loss? Are its members then required to make up the loss?

Mr. MENTZ. It depends on what the provisions of the co-op's charter and bylaws but are, usually, what would happen in the case of an established co-op would be that the loss would be held by the co-op and then next year, when there are sales, if there is a profit, the profit would be offset by the loss before the patronage dividend would be paid. The loss or profit is, of course, directly related to the price the co-op pays the farmers for the wheat or for whatever the commodity is. So, it is within the control of the cooperative, to some extent, to determine how the profits or losses work out, and that, as you will see when we get a little bit further along, is a relevant point in focusing in on some of these tax issues. As long as there is a binding obligation of the cooperative to pay out the profits as patronage dividends, there really are no tax issues in this regard for a one-product cooperative. But once you get into more than one product, it gets a little more complicated. And of course, that is the subject of our hearing this morning. Let me try and give you a couple of examples that illustrate the problems, Mr. Chairman, and then we can talk about what the solutions might be. One example would be a case where a cooperative buys wheat from its patrons and markets the wheat but also is engaged in nonpatronage activities, let's say, selling shirts or something that has nothing to do with its patrons. In that situation, if a cooperative is deliberately intending to take advantage of its cooperative status—and I am not suggesting that we have any particular cooperative in mind that is doing this—but just for purposes of illustration, the cooperative could arrange for the purchase of wheat from its farmers at a high enough price so that it would have a loss on its wheat. Let's assume it is buying a thousand units of wheat, and it loses $1,000 on that wheat and then the selling of it to third parties. And in its

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nonpatronage activities, its shirt business which has nothing to do with its patrons, it has a profit of $1,000. Now, if you just leave that situation alone and allow the loss to offset the profit so that there is no income to the cooperative, the economics of that situation are that, by design, $1,000 of profit earned on nonpatronage activities that has been transferred to the patrons. It has been transferred to the patrons by reason of a purchase price for the wheat that is higher than would ordinarily be the market price. And the effect of netting in that case is a transfer of earnings from the nonpatronage activity to patrons with only one level of tax.

Senator CHAFEE. We have got to move along here.

Mr. MENTZ. All right.

Senator CHAFEE. I don't think it does much good to take kind of bizarre illustrations because those who are involved certainly don't do that. As I understand it, there have been three Tax Court cases where Treasury has tried to enforce this tax, and failed every time.

Mr. MENTZ. The purpose of that example, Mr. Chairman, is to illustrate one basic point, which is that nonpatronage activities should not be subject to netting with patronage activities because there is a possibility of abuse there. And I think that point has been upheld by a Tax Court case, and I don't think there is going to be much argument on that from the coops themselves.

Senator CHAFEE. That is right.

Mr. MENTZ. But let's get a little bit closer to home with a case where you have two commodities, let's say, wheat and corn. On the wheat transactions, the cooperative makes $1,000; and on the corn transactions, the cooperative loses $600. Now, the cooperative can be organized in one of two ways. It can provide for netting. It can provide that it is going to pay patronage dividends only after losses from another activity are netted, in which case the cooperative would be obligated to pay $400 of patronage dividends to the wheat farmers that sold the wheat at a profit. While the IRS has had some problems with that and has sort of been up hill and down dale on that issue, I think that, at least preliminarily, there appears to be a good chance that we can come out with regulations that will basically sanction that approach, provided that the wheat farmers and the corn farmers know in advance that that is the way it is going to work; that you are going to have a netting; that if you sell your product at a profit, you might not get all the profit because the cooperative may be selling some other commodity at a loss. If that is up front and understood by both sets of farmers and you have the obligation—the cooperative has the absolute obligation—to pay out the net amount, I believe that we ought to be able to come out with regulations that say that is a permissible netting.

Senator CHAFEE. Isn't that the case we have here?

Mr. MENTZ. I am not prepared to discuss a particular case, Mr. Chairman. That would be improper.

Senator CHAFEE. I don't mean the cases of wheat and corn, but I mean, as I understand the problem before us, it is the exact one you have stated that you think you can solve.

Mr. MENTZ. That is a very large part of it, and that is why I said initially I think we can solve this problem by administrative action. I would point out to you that there isn't just one problem here; there are lots of them. One problem that can come up in that

situation is if the board of directors of the cooperative has discretion as to how much patronage dividends to pay out and makes independent judgments each year. For example, it has $60 of profit, but it decides to pay out only $30 or only $20. That is a problem the statute that provides for deduction for patronage dividends says the deduction is allowable only if there is a preexisting legal obligation to distribute the profits. So, if there is no preexisting obligation—in other words, if there is total discretion—then there isn't going to be a deduction allowed for that distribution. That is the same as a corporation whose board of directors decides how much dividends to pay on a purely discretionary basis. This concept of legal liability is the *sine qua non* to deductibility of patronage dividends, even if you otherwise allow netting. And where I think we are heading, and where the IRS is heading, with our gentle guidance, is to come up with a netting approach that would permit netting as long as you have all of the participants in the coop fully aware, fully apprised, that there is going to be this netting mechanism. But there must be a very clear understanding that deduction of the patronage dividends would only be allowed if there is the legal obligation to distribute the dividend, which is only in accordance with the statute.

Senator CHAFEE. What you are saying is that, in order for Treasury to permit this netting, there has to be a total payout after you net. Is that right?

Mr. MENTZ. Well, I suppose you could have it any way that the cooperative decided. If they passed the bylaw that said only 50 percent of the total profit would be paid out, that would be OK with us, but the deduction would be allowed only to the extent of the 50 percent. What problem we have is where the board of directors decides on a purely discretionary basis how much to pay out and then claims a deduction for the full amount of payout. And that is simply a violation of the present statute. It really doesn't have anything to do with netting. And it is something that, in the context of promulgating regulations, we would seek to fix, or I would say clarify, not fix.

Senator CHAFEE. Yes, I was going to say that, because you are saying that is the current law?

Mr. MENTZ. That is current law.

Senator CHAFEE. In other words, a co-op isn't entitled to the privileges of a coop if it doesn't pay out 100 percent or whatever percent of the patronage dividend that it has previously agreed to pay, that is written into its bylaws?

Mr. MENTZ. That is right. If the co-op can decide whatever it wants to pay, then it is really no different from General Motors. It is an entity that is engaged in business. It is making profits, and it is deciding how much to distribute to its shareholders. If it has this legal liability, then, if it is a cooperative, we would allow the deduction for the patronage dividend. I might come back to the point about——

Senator CHAFEE. We had better wind this up now. Why don't you take a couple of minutes and finish it up?

Mr. MENTZ. All right, fine. The main thrust of our proposed position on netting—and it really is proposed because we are not finished with the study—but the main point is that it is possible for

the wheat farmer not to know that he is going to have his profits offset by losses of the corn farmer. And that is basically unfair as a matter of—forget taxation—it is unfair as a matter of just practice. However if it is the intention of the cooperative and it is understood by all parties, that there will be netting and only the net profits will be paid out to the patrons, we don't think we have any objection to that. And as I said, we will seek to get regulations that would work this out.

Senator CHAFEE. All right. Let's see how you do then. I suspect the problem isn't going to be in the notification of the members that there is netting. I suspect that the co-op people who are going to testify will testify that, sure, we are perfectly willing to have that happen. We are not trying to pull the wool over the corn fellow's eyes by making him think that he might not suffer some diminution of patronage dividends by the fact that some of his money is being used to help out the wheat farmer. But the other part that you have that they must distribute the patronage dividends on some predetermined formula, instead of the directors having that discretion, which I presume they presently have—are you saying that under the present law, under the present tax laws, if there is this discretion on the part of the board of directors, it is no longer a co-op?

Mr. MENTZ. I would say that that is certainly the position that the IRS has taken. Whether it is——

Senator CHAFEE. Has it taken it successfully at any time? I mean, has that been challenged?

Mr. MENTZ. I don't know whether they have ever gotten it by successfully, but I do know that whether it is a co-op or not, the amount distributed, if not pursuant to a legal obligation, is not deductible. There is a very clear statute, and we just seek to have that statute enforced.

Senator CHAFEE. By the way, how many co-ops are there in other than agricultural matters? I don't mean in numbers, but percentagewise, roughly. Who else uses co-ops?

Mr. MENTZ. There are rural electric co-ops, of which some are very large. I don't know.

Senator CHAFEE. How about fishermen co-ops?

Mr. MENTZ. Yes, that is right. There are also consumer co-ops. This is an aspect of the Treasury study that we really haven't gotten that far along on, Mr. Chairman. Co-ops are, as you said, a rather arcane feature of the tax law and one that we need a little bit more time to work on. But I think I have given you the outlines of where we are heading, and I think it is something that we can work out administratively.

Senator CHAFEE. We will see, as we hear from the others.

Mr. MENTZ. That is right.

Senator CHAFEE. How they feel about the lack of discretion in the board of directors. All right, fine. Thank you very much, Mr. Mentz, for coming.

Mr. MENTZ. Thank you, Mr. Chairman.

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Senator CHAFEE. We appreciate it. The next panel will consist of Mr. Delaney, president of the National Tax Equality Association; Mr. Randall, executive vice president and general counsel, National Independent Dairy-Foods Association, accompanied by Mr. Shupe. If you gentlemen would come up? All right. Mr. Delaney, why don't you go first?

[The prepared written statement of Mr. Mentz follows:]

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For Release Upon Delivery
Expected at 9:30 a.m. EDT
July 15, 1985

STATEMENT OF
J. ROGER MENTZ
DEPUTY ASSISTANT SECRETARY
(TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
SENATE FINANCE COMMITTEE

Mr. Chairman and Members of the Subcommittee:

I am pleased to have the opportunity to present the views of the Treasury Department on the netting of income and losses by farm cooperatives. This hearing is in response to a floor amendment to the supplemental appropriations bill for fiscal year 1985, as reported recently by the Senate Committee on Appropriations. That amendment directed the Treasury Department to study cooperative netting issues. While our study has just commenced, I will share with you today the issues and tax policy considerations that have been identified. The Department of Agriculture, while not testifying here today, also may submit to this Subcommittee further information regarding the importance of netting to farm cooperatives. I would like to note at the outset that, while farm cooperatives are undoubtedly the largest and most prominent cooperatives in existence today, the issues under examination at this hearing are germane to numerous activities conducted by cooperatives, not just farm activities.

It is frequently the case that when special rules are incorporated in the tax code to accommodate uniquely situated taxpayers, such as farm cooperatives, taxpayers have a tendency to expand those rules beyond the bounds of their intended task. As a consequence, responsible administrators must restrain the freedom with which taxpayers interpret the boundaries of such rules. This, in turn, typically involves a careful balancing of competing concerns.

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The issue under study today, the practice of netting by farm cooperatives, requires just such a balancing. The practice is in some circumstances inextricably linked with the fundamental purposes of legitimate cooperatives, but in other circumstances netting may not be in the interest of the cooperative patrons and may indirectly contribute to the goals of those who would undermine the integrity of our system of corporate taxation. In order to establish a framework for understanding Treasury's attempt to strike an appropriate balance between these competing considerations, I will outline our normal system of corporate taxation, summarize the reasons for which farm cooperatives have received special treatment, and describe the history of the special statutory treatment of cooperatives. Finally, I will illustrate the tension between cooperative taxation and regular corporate taxation and describe why we feel it is appropriate for some constraints to be placed on the manner in which cooperatives are permitted to net income and loss from different activities.

Taxation of Corporations

In general, corporations are taxed on their earnings and owners of corporations are taxed when corporate earnings are distributed to them. Since distributions of corporate earnings are not deductible, distributed earnings are in effect taxed twice. This regime of "two-tiered" taxation applies to the great majority of corporations in America. Some closely held corporations with very simple capital structures may elect to be treated similarly to partnerships, and certain kinds of investment companies may avoid the corporate level tax by regularly distributing their earnings. But, as a general rule, business corporations and their owners are subject to a two-tier tax.

Throughout the history of our tax system, corporations have attempted to avoid one tier of tax by shifting corporate income to their shareholders. The Congress, the Internal Revenue Service, and the courts have acted to thwart those attempts where the income was actually earned by the corporation. Thus, if a corporation manufactures goods and distributes those goods to its shareholders, who then sell the goods at a profit, the profit will be taxed at the corporate level and the shareholders will be treated as receiving a taxable dividend.

Special Status of Farm Cooperatives

Before describing the special treatment of farm cooperatives under the Internal Revenue Code, I would like to outline briefly the role of farm cooperatives as it has been described to the Treasury Department by representatives of the agricultural community.

First, a farm cooperative provides a vehicle through which small farmers can combine to benefit from efficiencies of scale,

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increased market power, and enhanced capital formation opportunities. Second, a diversified farm cooperative can enable its members to insulate themselves to some extent from the volatility and uncertainty of agricultural production and distribution. Third, the cooperative form enables farmers to obtain these benefits without relinquishing control or profits to equity investors whose interests might not coincide with those of the farmers.

In order to accomplish these objectives, farm cooperatives usually are organized so that shares of capital stock or other equity interests are owned by patrons in amounts roughly proportional to patronage with each equity owner being limited to a single vote. Net earnings also typically are allocated in accordance with patronage. With such a structure, a farm cooperative is more likely than an ordinary investor-owned corporation to serve the interests of its patrons.

The current Internal Revenue Code encourages farmers, and others, to utilize the cooperative form to obtain these benefits. It permits the corporate level tax to be eliminated where the cooperative's profits are attributable to activities conducted for the mutual benefit of all of its patrons, provided those profits are in fact distributed or allocated equitably to the patrons.

History of Tax Rules Governing Cooperatives

Subchapter T of the Internal Revenue Code contains the rules providing relief to certain cooperatives from the two-tier tax. Those rules govern the taxation of most cooperatives, including farm cooperatives. By its terms, Subchapter T applies to farm cooperatives described in section 521 and, in general, other corporations "operating on a cooperative basis." According to section 521, farm cooperatives also must be "organized and operated on a cooperative basis." Although section 521 states generally that a farm cooperative meeting the requirements of that section is exempt from taxation, the apparent exemption is explicitly qualified by a reference to Subchapter T, which provides that farm cooperatives are subject to the regular corporate tax. Thus, Subchapter T applies only to organizations that operate on a cooperative basis, and, subject to certain special deductions allowed under Subchapter T, those organizations are all subject to the corporate tax.*/

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*/ The "exemption" from tax provided farm cooperatives described in section 521 is not a true exemption. Rather, section 521 cooperatives are entitled to deduct (1) dividends paid on capital stock and (2) amounts paid to patrons on a patronage basis from earnings derived from business done for the United States or from other nonpatronage sources. Non-exempt cooperatives are not entitled to these deductions.

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Subchapter T was enacted in 1961 because of Congress's concern that cooperative patronage income was escaping taxation entirely. This concern arose because of the liberal treatment of non-exempt cooperatives by the Internal Revenue Service. For many years, despite the absence of any specific statutory provisions, the Service had permitted a non-exempt corporation operated on a cooperative basis to deduct from its income certain qualifying amounts of patronage earnings that were retained by the corporation, provided they were allocated to patrons pursuant to a pre-existing obligation. However, some courts held that a non-interest-bearing certificate representing the patron's conditional right to receive retained amounts allocated to his account had contingent value only and therefore was not taxable when distributed to the patron. As a result, patronage income allocated to patrons by means of non-interest-bearing certificates escaped current taxation at both the corporate and patron levels.

In order to ensure that all patronage income would be taxed currently, Congress enacted Subchapter T. The provisions of Subchapter T generally codified the prior administrative practice with respect to the requirements for deductible distributions of patronage earnings. They made it clear, however, that all patronage income must be includable in the taxable income of either the cooperative or the patrons, and established rules for determining the circumstances in which the tax incidence of patronage income has been shifted from the cooperative to its patrons, as well as the time for reporting that income. If an organization either is not operated on a cooperative basis or does not comply with the specific requirements regarding the payment of patronage earnings to patrons, the organization cannot avail itself of the special Subchapter T deductions for distributions to patrons.

An important condition on the deductibility of patronage earnings, both under Subchapter T and under prior administrative practice, is that the allocation of the earnings be made pursuant to a pre-existing obligation to the patron. Section 1388 expressly provides that a "patronage dividend" means:

> an amount paid to a patron by [a cooperative] under an obligation of such [cooperative] to pay such amount, which obligation existed before the [cooperative] received the amount so paid.

Thus, if a cooperative distributes patronage earnings to its patrons, but had the discretion to use those earnings for purposes other than making that distribution, the distribution is not a deductible patronage dividend.

Use of the Cooperative Form to Avoid the Corporate Tax

It does not follow, of course, that a corporation should be permitted to escape the corporate tax on its profits simply by

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calling itself a cooperative, if the activities from which it derives its profits are not conducted for the mutual benefit of all of its patrons. Indeed, it has been held that a cooperative may not offset nonpatronage earnings with patronage losses and thereby avoid the corporate tax on the earnings derived from nonpatronage activities. Farm Service Coop. v. Commissioner, 619 F.2d 718 (8th Cir. 1980). The Farm Service case makes it clear that nonpatronage income is to be taxed at the corporate level. Similarly, there are instances in which patronage income should be taxed at the corporate level. The mere fact that all of a corporation's profits are distributed on the basis of patronage should not negate the corporate tax.

It is not difficult to see how patronage of a corporation ostensibly organized as a cooperative may be used in an attempt to eliminate the corporate tax in situations where that tax unquestionably should be imposed. Assume, for example, that a corporation is owned by shareholder/patrons. The corporation sells $10,000 worth of widgets to 1,000 of its shareholder/patrons and earns a $1,000 profit on those sales. Assume also that the corporation markets $20,000 worth of shirts produced by five of its shareholder/patrons and pays those patrons $21,000 for those shirts, creating an offsetting $1,000 loss. If the five patrons who produce shirts effectively control the corporation (because voting is on a patronage basis or because no widget patron has enough of a stake in the corporation to make voting worthwhile), and no distribution of the profit on the widgets is made to the widget patrons, it appears that the shirt patrons have used their patronage of the corporation as a device for distributing to themselves the $1,000 profit earned by the corporation from widget sales.

If the corporation in this example is taxed as an ordinary corporation, the artificial loss created by the excessive payments for shirts will be recharacterized as a nondeductible dividend and the corporation will be taxed on its $1,000 profit from the sale of widgets. However, if the corporation can successfully maintain that it is a cooperative, some would argue that those shareholders in control of the corporation may decide that the corporation has no profit -- by netting the $1,000 "loss" from shirt sales against the $1,000 profit from widget sales -- and that the government has no right or power to question that decision. Moreover, some would argue that the corporation is a cooperative as long as the persons controlling the use of the corporation's profits are patrons of the corporation (which the five shirt producers are) and the corporation is contractually obligated to distribute its profits (if any) to its patrons in proportion to their patronage. In the example above, if the "loss" from shirt sales is respected as a loss, as opposed to a disguised dividend, the corporation has no profits to distribute. While it may appear that the widget patrons should be entitled to the $1,000 profit that arose from their patronage, the corporation will assert that it satisfies the requirement that profits are distributed in proportion to patronage.

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The targeted distribution of profits to particular patrons can, in many cases, be accomplished with equal facility even if all patrons exercise equal voting rights. Assume, for example, that a cooperative corporation has 100 patrons, each of whom has a single vote. Sixty of the patrons market wheat through the cooperative, and forty of the patrons market corn. During the year, the cooperative loses $1,000 from its transactions with wheat patrons (by virtue of excessive advances) and earns $1,000 from its transactions with corn patrons. The cooperative's bylaws give the board of directors the discretion either to pay a $1,000 patronage refund to the corn patrons (and charge the $1,000 loss to the wheat farmers' capital accounts) or to "net" the profits and losses and determine that the cooperative has no net earnings to distribute. The wheat patrons, who hold 60 percent of the votes, can cause the board to take the latter action. In fact, in some circumstances it appears that the corn patrons may not even be informed that this has been done. Operation of a cooperative corporation in this manner serves to transfer corporate profits to the controlling wheat patrons. Since a $1,000 dividend distribution to the wheat patrons would not be deductible by the corporation, the corporation should have taxable income of $1,000.

I do not mean to suggest that farm cooperatives avoid corporate tax by operating in the manner of the hypothetical widget seller or the hypothetical wheat and corn cooperative. I simply want to point out that there must be some limits on the operation of cooperatives in order to prevent inappropriate avoidance of the corporate tax. The difficulty is in identifying cases where abuse has occurred, and in developing fair, administrable rules that can be applied in all cases.

The Netting Issue

Although the term "netting" generally refers to the offsetting of losses against profits, as a technical matter we have identified four separate netting issues. The first issue is whether and in what situations a cooperative may, without losing its cooperative status, shift wealth from one group of patrons to another by using profits from the former's patronage to subsidize patronage losses from the latter. The second issue is whether a cooperative that sustains losses from one category of patronage and earns profits from another category of patronage may deduct the losses from the profits in computing its corporate taxable income. The third issue is whether a cooperative may be said to have a "pre-existing obligation" to pay patronage dividends to the patrons of a profitable activity if it has the discretion either to distribute those profits to the patrons whose patronage generated the profits or to net the profits against losses from another activity, thereby using the profits to subsidize those losses. The fourth issue is whether a farm cooperative that operates both purchasing and marketing activities, and nets losses from one against profits from the other, may qualify as an "exempt" farm cooperative described in section 521.

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In attempting to resolve these issues administratively, the Treasury Department must weigh the legitimate needs of cooperatives against the government's responsibility to apply the corporate tax to business organizations that are not the intended beneficiaries of Subchapter T.

The Importance of Netting to Farm Cooperatives

Since diversification of risk is a significant function of farm cooperatives, it is axiomatic that, to some extent, profits from some patronage activities will be used to offset losses from other patronage activities. In general, no abuse will exist where a cooperative's members agree in advance that patrons of an activity that produces unanticipated losses will not be required to repay those losses but instead will be cushioned by profits from other patronage activities. In such cases, both of the first two netting issues mentioned above come into play; wealth is transferred from the profitable patrons to the loss patrons, and patronage profits and losses will be netted for tax purposes.

Similarly, there may be numerous legitimate reasons why a cooperative's members may agree in advance that the cooperative's directors have the discretion to subsidize losses from some patronage activities with profits from other activities. The shifting of wealth from profit-generating patrons to loss-generating patrons that occurs through discretionary netting may be fully consistent with the purposes for which cooperatives are encouraged, particularly if the patrons are fully aware that the discretion exists and are periodically given information describing in adequate detail the netting that has been effected. Nonetheless, under the provisions of the present tax code, one of the consequences of giving the directors this discretion is that the deduction for patronage dividends may be limited or even eliminated as a result of the cooperative failing to meet the pre-existing obligation requirement.

Unbridled and unreported discretion, on the other hand, can lead to the abuses described above. For example, if a cooperative is controlled by patrons of one of its activities, management may choose to net profits and losses in years in which that activity generates a loss, but not in other years. If the patrons of the cooperative's other activities are not informed of management's netting practices, they will not know that a portion of the profits generated by their patronage has been appropriated systematically by the controlling patrons.

Judicial Decisions

On several occasions, the courts have addressed the tax consequences of the allocation by cooperatives of profit and loss among their patrons. Some have asserted that these cases resolve the netting issues discussed above, and thus that these issues are inappropriately raised by the Service. While these judicial

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decisions have a bearing on the netting issues that are the subject of this Subcommittee hearing, we are strongly of the view that they do not resolve these issues.

In Associated Milk Producers, 68 T.C. 729 (1977), the Tax Court rejected the Service's contention that a cooperative must always recoup an economic loss from the particular patron whose patronage created the loss. In the Associated Milk Producers case, the court found that the loss had been caused by bad management and it would have been injudicious for the cooperative to attempt to recoup the entire loss from those persons who were patrons in the loss years. Under those circumstances the court held that it was a reasonable management decision to charge the losses against patronage income from subsequent years.

In Ford-Iroquois FS, Inc., 74 T.C. 1213 (1980), the Tax Court held that the taxpayer, a non-exempt farm cooperative, was entitled to apply losses incurred in 1971 and 1972 in its grain marketing and storage operations against income earned in 1973 from its farm supply operations. In reaching this conclusion, the court stressed that there was substantial overlap between the patrons of the loss operations and the patrons of the profitable operation, and also that the cooperative's members had frequent contact with the board of directors, received annual financial reports from the cooperative, and appeared to find the allocations fair.

In Lamesa Cooperative Gin, 78 T.C. 894 (1982), the Tax Court rejected the Service's contention that a cooperative's recapture income from the sale of depreciated equipment must be allocated to patrons in accordance with patronage during the years in which depreciation deductions were claimed. The court also held that it was not inequitable for the cooperative to allocate a small amount of net income from its purchasing activities in accordance with patronage of its marketing activities. In the case of the allocation of recapture income, the court found that it would have been impossible to match the income precisely with prior patronage and that the cooperative's decision to allocate the income in accordance with patronage in the year of sale was reasonable and equitable. Similarly, in connection with the allocation of purchasing income, the court found that the patrons of the purchasing and marketing activities were not significantly different and that the small size of the purchasing activity made it reasonable not to account for the activity separately.

Some may assert that the Ford-Iroquois and Lamesa cases preclude the Service from asserting that marketing and purchasing operations must be accounted for separately by an exempt cooperative. It should be noted, however, that the Ford-Iroquois case did not involve an interpretation of section 521 of the Code, which reasonably can be read to require such separate accounting. Moreover, in reaching its decision in Lamesa, the Tax Court stated that the exempt cooperative's purchasing activity was so small relative to its marketing activity that

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maintaining separate accounting records with respect to the separate activities might have cost the cooperative almost as much as its entire profit from the purchasing activity. The court also stated:

> Boards of directors of cooperatives do not have carte blanche to make whatever allocations they choose, but we believe respondent should recognize that directors have some discretion, some flexibility, in the exercise of business judgment. Only when unreasonable exercise of that discretion appears should the board's weighing of the equities be overturned by this Court. (78 T.C. at 906).

The Position of the Treasury Department

The Treasury Department is not, as a matter of tax policy, opposed to farm cooperatives conducting their business through flexible and adaptable management policies, nor is the Treasury opposed to the netting inherent in risk diversification. However, Treasury does have concerns with proposals to give cooperatives and, indirectly, their boards of directors, carte blanche netting powers.

Treasury believes that the Internal Revenue Service should have the authority to examine the activities of any cooperative corporation and take appropriate action where abuse is uncovered. As pointed out, it is possible for patrons who are in control of a cooperative corporation to use that control to extract dividends in the guise of patronage losses. Abuse of the cooperative form of operation in this way must not be insulated from the scrutiny of the Internal Revenue Service. Any legislative or administrative clarification of the cooperative netting issues will have to recognize that disguised dividends of this type cannot under any circumstances be availed of to avoid the corporate tax.

In addition, as I have also illustrated, without adequate safeguards requiring advance consent from patrons or at least regular reports to patrons regarding how profits and losses from various patronage activities are to be netted, it is possible, through their discretionary netting powers, for those persons who control a cooperative corporation to shift wealth systematically to themselves or favored patrons from other uninformed patrons. Such activity is inconsistent with the intent of Subchapter T to provide limited relief from the corporate tax to cooperatives operated for the mutual benefit of all of their patrons. The Internal Revenue Service should not be powerless to act if it uncovers such abuses.

The present statutory scheme for taxing cooperative corporations places some limitations on discretionary netting. Because abuses can arise from discretionary netting, we do not believe that the Service is in error when it interprets these

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limitations strictly. Thus, we do not believe the Service's interpretation of the pre-existing obligation limitation is unreasonable. That is, when discretion is granted to a cooperative's management to net losses of one activity against profits from a second, to the extent of the loss from the second activity the cooperative does not have the required pre-existing obligation to distribute profits to the patrons of the first activity, and, therefore, cannot treat the entire distribution as a deductible patronage dividend if it chooses not to net.

Finally, I wish to point out that some of our concerns regarding the cooperative netting issues would be diminished if there were legislative or administrative rules that insured that all patrons were adequately informed about the netting decisions of the cooperative.

Treasury believes, however, that the netting issues that are the subject of this hearing can and should be resolved administratively, through the regulations and rulings process. If no such administrative guidelines are promulgated, abuses of the type we have described surely will spread and new abuses will develop. Accordingly, Treasury will continue to explore, in cooperation with the Department of Agriculture and the cooperative industry, the feasibility of establishing these administrative guidelines. If the Congress, however, decides that these issues should be resolved legislatively, we believe it should simultaneously clarify some of the other major unresolved issues involving the taxation of cooperatives that are unrelated to the netting issue.

That concludes my prepared remarks. I would be pleased to respond to any questions.

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STATEMENT OF EDWARD N. DELANEY, PRESIDENT, NATIONAL TAX EQUALITY ASSOCIATION, WASHINGTON, DC

Mr. DELANEY. Thank you, Mr. Chairman.

Senator CHAFEE. You have your full statement submitted for the record. Why don't you each take 4 minutes? If there is additional time needed, we will work on that.

Mr. DELANEY. All right. Thank you. Mr. Chairman, we have in our statement an analysis of current law on cooperative taxation and some points that we feel are important for the committee to consider. Rather than go into that lengthy explanation, I am going to summarize our statement and restrict comments to two issues. We have some general tax policy concerns about allowing netting for cooperative corporations, and we also have some specific concerns about the competitive impact in agribusiness of allowing additional tax benefits for cooperatives. The National Tax Equality Association is a tax reform and deficit reduction group with about 1,500 business members. We have about 300 firms involved in agribusiness, and for many years, we have expressed a concern about special tax treatment or favored tax treatment, as we view it, for cooperative corporations. Most of the companies are involved in grain, feed, and seed and fertilizer sales and similar agricultural products. For a number of years, these proprietary businesses have been concerned about their cooperative competition for a couple of reasons. They feel the competition is unfair due to various benefits provided by the Government. And the growth of this competition has been significant. In March 1983, Purdue University issued a study outlining growth of cooperative firms as compared to proprietary firms. The annual growth rate from 1970 to 1980 of total sales in grain and farm supplies equalled 17 percent for cooperative firms, compared to about 11.5 percent for other firms. During the period from 1950 to 1977, the total co-op market shares of various commodities and farm supplies grew from 20 to 29 percent. Now, this type of growth, of course, is the primary goal of any business firm, but we have a problem with it because we feel our firms are at a competitive disadvantage because of the number of benefits provided cooperatives by Federal Government. The special dividend deduction is one benefit. Exemption from the minimum tax on preference items for corporations is a benefit. The below market rate financing of the banks for cooperatives, which is generally available to farm cooperatives and some limited antitrust exemptions.

Senator CHAFEE. I will bet the third one you mentioned, the below market rate financing, is probably as significant as any. Isn't it?

Mr. DELANEY. Yes; it is very significant.

Senator CHAFEE. In other words, are we talking de minimus here, when we are talking the special dividend deduction, compared to the others?

Mr. DELANEY. I would put the dividend deduction as a very important benefit for cooperatives. The Joint Tax Committee estimated the dividend deduction to be about $1 billion revenue loss item. So, it is a significant tax reduction item. The banks for cooperatives provided about, I believe, $50 billion in financing last year.

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Because of the competitive inequality, as we view it, and general tax policy considerations, we oppose providing additional tax benefits to cooperatives through the netting procedure. We feel that considering a new tax break for corporations at this time undermines tax reform discussion and really undermines the opportunity for this Congress to restore faith in our tax system. One of the primary concerns that surveys have shown of individuals across the country is that they feel there are many corporations with low or negative tax rates, and they are disturbed about that. And that is one of the primary motivations to support sweeping tax reform. We feel that Congress should strive to ensure that vital components of fair tax reform are advanced. Similar incomes should be taxed in a similar manner. Special interest provisions should be scrutinized to ensure that the benefits of these provisions are limited to those groups and not that we have lost track of where the benefits are going. Probably a continual monitoring of tax benefits would be in order. A successful push for special tax deduction legislation at this time, we feel, will spur other interest groups to request similar benefits. Senator Mattingly expressed concern on the floor in his statement on this issue about the economic conditions faced by farmers and raised the issue that many cooperatives would go out of business and would be a total disaster if netting was not allowed cooperative corporations. Now, Treasury doesn't have revenue estimates for the netting issue or for what impact it would have, but we feel that it is doubtful that the absence of this additional corporate tax mechanism could make that kind of staggering difference in the agricultural economy. Congress is going to pass a bill soon that will distribute about $14 billion in 1986 to farmers in various price support programs. Perhaps this tax break money that the cooperatives are interested in would be better used if distributed to individual farmers through a farm credit relief program or one of the other programs. If our primary concern is the family farm, why don't we direct the aid to that farm? We have had some discussions with Senator Symms on this issue, and he has stated that our agribusiness should probably pursue similar tax reductions, some type of dividend deduction for agribusiness firms or other mechanisms to bring their tax rates down to a level where the cooperative effective tax rate is. Perhaps that is an idea that the committee should consider. It is very difficult in these times of deficit reduction. So, rather than going that route, we would recommend not providing the additional tax benefits of netting. The issue of netting involves many concerns in addition to general tax policy. IRS has opposed the use of netting because of the impact on members of cooperatives. NTEA has long argued that the special benefits of cooperatives should be questioned because the characteristics of many cooperative firms appear to be similar to that of any corporation, rather than a cooperative type structure. This is fundamentally the point the IRS has taken. Are the co-ops serving their own cooperative interests or operating only for the benefit of members? The use of netting, I believe, would indicate an interest in serving the corporate's own interests, rather than the members; if they cannot determine or identify the individual members who should receive the benefits of netting the loss against the income. The IRS has raised a valid point in examining the equity of netting losses of one divi-

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sion of a co-op against the income of a different division or function. For a co-op to operate in a cooperative manner, it must allocate benefits and losses in an equitable manner, according to the rules outlined in subchapter (t) of the code. Failure to uphold this basic service to members on behalf of any co-op demonstrates a lack of regard for the welfare of the individual farmer member. This committee must carefully consider the technical aspects of this issue and not disregard the impact of its action on tax policy and the future of tax reform. The remainder of my statement for the record, Mr. Chairman, details our views on current law and the impact on agribusiness firms.

Senator CHAFEE. All right, fine. Thank you very much, Mr. Delaney. And the next witness will be Mr. Randall.

[The prepared written statement of Mr. Delaney follows:]

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STATMENT OF EDWARD N. DELANEY II

ON BEHALF OF THE NATIONAL TAX EQUALITY ASSOCIATION

BEFORE THE SENATE FINANCE COMMITTEE

BOB PACKWOOD, CHAIRMAN

MONDAY JULY 15, 1985

STATEMENT HIGHLIGHTS

Mr. Chairman, Members of the Senate Finance Committee, my name is Edward Delaney, and I represent the National Tax Equality Association, a tax reform and deficit reduction policy group. NTEA commends Chairman Packwood for scheduling these hearings on a difficult subject during such a hectic period for the committee. We appreciate the opportunity to present testimony.

Out of our 1500 business members we have about 300 firms involved in agribusiness. Most of the companies are involved in grain, feed and seed, implement sales, fertilizer sales and similar agricultural products. For a number of years these proprietary businesses have been concerned about growing competition from cooperative corporations, and the growth has been significant. In March of 1983, Purdue University's Dept. of Agricultural Economics issued an interesting study outlining growth of cooperative firms as compared to proprietary firms. The annual growth rate from 1970-1980 of total sales in grain and farm supplies equaled 17 percent for co-op

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firms compared to 11.5 percent for other firms. During the period from 1950 to 1977, total co-op market share for various commodities and farm supplies moved from 20 to 29 percent. Although growth should be the goal of all business operations, our firms are at a distinct competitive disadvantage because cooperatives have lower effective tax rates due to a special dividend deduction and an exemption from the minimum tax on preference items; below market-rate financing through the Banks for Cooperatives; and limited anti-trust exemptions.

This government-favored competition is especially troublesome when generated by the largest 50 or so co-ops with hundreds of millions of dollars in sales annually.

Because of competitive inequality and general tax policy considerations, we strongly oppose providing additional tax benefits to cooperatives through the "netting" procedure. Considering a new tax break for corporations mocks any serious tax reform effort and undermines the opportunity for this Congress to restore faith in our tax system. Instead, Congress should strive to ensure that vital components of fair tax reform are advanced. Similar income should be taxed in a similar manner. Special interest provisions should be scrutinized to guarantee that the benefits intended for certain groups are limited to those groups or individuals. Also, a successful push for special tax reduction legislation will spur other industries to request similar benefits.

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How many corporations can we accommodate without adding billions of dollars to the deficit and continuing to complicate the tax code with layers of special exemptions?

Senator Mattingly (R-GA) expressed his concern about the difficult economic conditions faced by farmers and raised the specter of great disaster for cooperatives and the farm economy if this special tax provision is not allowed. It is doubtful that the absence of this corporate tax practice could make that kind of difference. Soon the Congress may pass a farm bill which will distribute approximately $14 billion to farmers in cash payments to support their income. I suggest that we take the tax break money the cooperatives are asking for today and help the farmer by adding that money to the price support program or to a credit relief program.

What about the thousands of non-cooperative farm suppliers facing similar economic difficulties? Perhaps we should recommend some method of tax reduction for all agribusiness firms.

Of course, the prospect of allowing "netting" for cooperatives involves many concerns in addition to general tax policy. The IRS has opposed the use of "netting" because of the impact on members of cooperatives. NTEA has long argued that the special benefits of large cooperatives should be questioned, because the characteristics of many cooperatives appear to be similar to that of any corporation. Large co-ops are serving their own corporate interests rather than operating only for the benefit

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of members. This is clear in the attempt to use "netting" of losses and income from different divisions or functions when members can not be clearly identified to receive the benefits because they deal in different commodities, or are in different geographic regions. We believe that the IRS has raised a valid point in examining the equity of "netting" losses from one division of a co-op against the income of a different division or function. For a co-op to operate in a "cooperative manner" it must allocate benefits and losses in an equitable manner according to rules outlined in Subchapter T of the IRC. A number of court cases including Ford-Iroquis FS, Inc. Commissioner,74 T.C. 1213, 1218-1219 (1980), Lamesa Cooperative Gin v. Commissioner, 78 T.C. 894,990 (1982),and Pomeroy Cooperative Grain Co.v.Commissioner, 288 F. 2d. 326 (8th,Cir. 1961) affirm the concept of equitable distribution among membership.

Failure to uphold this basic service to members on behalf of any co-op using "netting" demonstrates a lack of regard for the welfare of the farmer/member in lieu of the corporate interest.

This committee must carefully consider the technical aspects of this issue and must not disregard the impact of its actions on tax policy and the future of tax reform. Obviously, we have strong views about the taxation of cooperatives and feel that Section 521 and Subchapter T should be reviewed by the committee. The remainder of our statement serves to initiate such review with an examination of current tax law, impact of the law on agribusiness firms and farmers, and possibilities for reform.

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INTRODUCTION

The National Tax Equality Association supports a reform of Federal tax policy regarding the establishment of a more neutral corporate tax system. Disparities in tax rates from business to business within industry sectors and also from industry to industry creates competitive inequality resulting in economic inefficiency. An area of tax inequality of particular concern to this association involves special tax benefits and exemptions for commercial non-profits who compete with tax-paying businesses.

In a November 1983 report entitled "Unfair Competition By Nonprofit Organizations with Small Business: An Issue for the 1980's," the Small Business Administration examined the impact of providing regulatory and tax advantages to non-profits actively pursuing commercial business. The report found that the non-profits "represent a source of significant and frequently unexpected competition for small businesses operating in the same industry." The report went on to suggest some specific remedies for the problem in legislative changes in Federal tax laws and procurement law. The NTEA generally endorses the report and finds the investigation a worthwhile contribution to the dialogue on this very specific and highly important problem. We do, however, urge the SBA to continue to examine the entire small business community to broaden the scope of information available on non-profit competition with for-profit business.

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To assist in this effort, we are providing an analysis of the growing problem of competitive equity between non-profit cooperative corporations and small businesses in the following report.

Cooperatives are business enterprises in which the customer or "patron" of the firm is also the owner. Most co-ops are organized under state incorporation laws and thus possess the peculiar corporate legal characteristics of limited liability, entity status, and perpetuity. The act of incorporation establishes a legal entity with an existence independent and apart from its owners. Individuals who form cooperatives constitute a group wishing to consolidate their buying power in order to increase the financial benefits of the marketplace. Traditionally, the co-op has had the reputation as a "self-help" organization for groups of individuals perceived to be at some economic disadvantage. This is no longer a common trait for cooperatives, as hardware co-ops, office supply co-ops, energy related co-ops and many others accept all income groups as participants for the purpose of maximizing financial benefits.

As a corporation, the co-op enters into contracts in its own name and the patrons are not bound by the corporate acts. Co-ops operate for their own account and retain corporate employees. The legal relationship between the co-op and its owner-patrons is essentially identical to that of any other corporation.

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The cooperative structure includes three basic tenets that are absent in investor-owned businesses. First, the earnings of the co-op are distributed to the owners on a basis of patronage. Second, the return on capital is usually limited to a maximum of 8 percent. Third, the amount of stock ownership which any one individual stockholder may possess is limited, and that, regardless of the amount owned, each stockholder has only one vote at the stockholder's meeting.

Cooperative businesses are usually associated with agribusiness, and most of the total revenue dollars of co-ops are in the agribusiness sector, but the cooperative business format also has developed or is developing in a number of business sectors including furniture retailing, grocery retailing, financial consulting, energy related businesses and auto parts supply and repair and hardware supply. [1] As of 1983, eight co-ops were listed on the Fortune 500 list of largest industrial corporations and nine on the Fortune Service 100 list.

Cooperative growth continues, and, NTEA maintains that this growth is due to individuals' desire to obtain the benefits of favored government policy.

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[1] For instance, Cotter & Company, a wholesale hardware cooperative is exempt from federal income taxes on all profits distributed or allocated to members as patronage dividends. Cotter & Company, and its cooperatively held subsidiary, True Value Hardware, had sales volume of $1.35 billion in 1981.

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This analysis will concentrate on the tax benefits available to co-ops, and how such benefits provide competitive advantages and damage competing small businesses. Before we look at that subject further, please take a moment to consult the following table, which indicates the size of today's dominant cooperatives.

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Table I This chart shows cooperatives on the Fortune 500 and Service 100 list along with total sales figures and rankings.

COOPERATIVE	SALES (in thousands)	Fortune 500 1983 Rank	Service 100 1982 Rank
Agway	3,768,212	98	
Land O' Lakes	3,264,792	121	
Gold Kist	1,461,424	238	
Farmer's Union Central Exchange	1,409,085	243	
Mid-America Dairyman	1,356,622	247	
CF Industries	862,048	328	
National Cooperative Refiner Assoc.	784,360	348	
Michigan Milk Producers Association	562,038	430	
Sun Diamond Growers of California	522,199	447	
Wisconsin Dairies Cooperative	447,555		
Farmland Industries	5,614,439		6
Associated Milk Producers	2,634,778		15
AGRI Industries	2,317,988		20
Grain Terminal Association	2,309,463		21
Dairymen	1,152,430		50
Southern States Cooperative	684,834		76
Sunkist Growers	688,834		77
Landmark	644,723		81
Union Equity Exchange	639,355		83

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SUMMARY OF FEDERAL INCOME TAX TREATMENT OF COOPERATIVES

I. INTRODUCTION

Corporations operating on a cooperative basis fall into several categories insofar as their federal income tax treatment is concerned.

This section summarizes the tax situation respecting cooperatives in the ordinarily understood sense. The tax treatment of such organizations is covered by IRC §521 and Subchapter T of the Internal Revenue Code which is entitled "Cooperatives and their Patrons." Subchapter T specifically excludes from its coverage a group of specialized institutions, such as mutual savings banks, rural electric and telephone cooperatives, and certain charitable organizations, each of which is especially provided for either in other parts of the Internal Revenue Code or in the substantive law governing the institution.

The cooperatives with which NTEA is concerned may be divided into three major categories: tax-exempt farm cooperatives; nonexempt farm cooperatives and nonfarm cooperatives. These categories are treated alike in at least one major respect. Specifically, patronage dividends which cooperative corporations allocate to their patrons may be deducted in determining taxable income of the cooperative provided the patron consents to take the same amount into his own individual income tax liability.

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II. CURRENT FEDERAL INCOME TAX TREATMENT OF COOPERATIVES

Cooperatives generally, whether farm or nonfarm, whether exempt or nonexempt, may deduct the face amount of certain distributions made to their patrons in computing their taxable corporate income.

Sections 1381 to 1388 of the Internal Revenue Code provide the method of computing the taxable incomes of cooperatives and their patrons. These sections were enacted in the Internal Revenue Act of 1962. Prior to that legislation, cooperatives had been allowed to exclude from their income the face amount of noncash patronage dividends while the patrons, although required to include the fair market value of these patronage dividends, valued them at zero. Since only the fair market value of the distributions was subject to individual income taxation, the patron also avoided federal income tax. The Internal Revenue Act of 1962 attempted to close this loophole under which neither the cooperative nor the patron paid any tax on non-cash patronage dividends. The theory of the 1962 act was to assure that these distributions would be taxable to either the cooperative or the patron. Briefly, the Act required that in the case of noncash dividends, at least 20% of the distribution must be in cash and the patron must include, in his individual income, the face amount of noncash distribution--even if there was no fair market value.

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The present state of cooperative taxation, and the main area of concern to the National Tax Equality Association, is the continued ability of co-ops to deduct from their taxable income allocations known as patronage dividends or, in the case of marketing cooperatives, per-unit retains. After taking the deductions for patronage dividends and/or per-unit retains, the cooperative is subject to the regular corporate income tax rates.

All of the federal income tax law applicable to cooperatives, enacted since 1962, has related to patronage dividends or per-unit retains.

1. Patronage Dividends

Patronage dividends are distributed by a cooperative to its patrons out of the earnings of the cooperative. Patronage dividends may be paid in money, property or certificates of allocation. Patronage dividends are defined as amounts: (a) distributed under an obligation existing before the paid amount was earned by the organization, (b) determined on the basis of business done with or for the patron, and (c) determined by reference to net earnings from business done with or for patrons. IRC §1388(a). These amounts, patronage dividends, may be deducted from gross income of the cooperative under certain conditions. The principle condition is the previous consent of the patron to include the same amount in his individual income. To be deducted by the cooperative for a particular taxable year, the patronage dividend must relate to patronage during that year and

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must be paid or allocated to the patron within 8-1/2 months after the end of the year. If a noncash notice of allocation is declared then 20% or more must be in the form of money, or qualified check. IRC §1388(c). This provision effectively allows the cooperative corporation to retain 80% of the declared dividend as tax-free at the corporate level. While considering the Tax Reform Act of 1969, the House of Representatives enacted a provision to increase the 20% cash payout to 50%; but this provision was not adopted by the Senate and did not become law.

2. Per-Unit Retains

A per-unit retain certificate is issued to a patron to reflect the retention by the cooperative of a portion of the proceeds from the marketing of products for the patron. Through the Revenue Act of 1966 and the Tax Reform Act of 1969, per-unit retains are treated equally, for deductibility purposes, as patronage dividends. In other words, cooperative corporations are allowed to deduct amounts allocated to their patrons as per-unit retains. Again, the patron must include the amount allocated to his account in his gross individual taxable income. See generally IRC §1385.

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SUMMARY

Cooperatives are nominally subject to corporate rates of taxation. However, co-ops are allowed a deduction from taxable income equal to the amount of co-op earnings allocated to the co-op patron. This allocation is usually referred to as either a patronage dividend or a per-unit retain.

Patronage dividends and per-unit retains do not need to be cash payouts to qualify the co-op for the deduction. The tax code only requires that 20% of the dividend be in cash. The balance may be returned to the patron in certificate form--bearing no interest. The patron pays individual income tax on the entire allocation, whether cash or certificates. This creates cash flow difficulties for many farmers who are already experiencing income problems. Some have suggested that the co-ops be required to pay cash dividends of at least 50% rather than 20% if they are to benefit from special deductions. NTEA agrees that would be a reasonable policy. Currently, the co-op may retain--in corporate control--80% of the declared patronage dividend as untaxed capital to be used for expansion, merger and market competition.

This system of taxation is obviously much different from that of non-cooperative corporations. The income of non-co-op corporations is subject to federal taxation at two levels--corporate and individual (when distributed as dividend income)--while cooperative earnings are virtually tax-free at the

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corporate level. The different tax treatment clearly places the co-op at an advantage when competing with non-cooperative enterprises.

The following table 2 of this report outlines the effective tax rates for large cooperative companies for the years 1982 and 1983. Co-ops examined include those listed on the Fortune 500 and Service 100 that responded to request for annual reports.

Table 2 Tax Rates for Cooperatives listed on Fortune 500 and Service 100 List

Part 1 Effective corporate taxation of cooperatives for 1982.

		Tax Rate	Income
1)	Farmers Union Central Exchange	4.8%	$15,927,967
2)	Dairymen	2.7%	$14,755,000
3)	Goldkist	24.0%	$ 7,181,000
4)	Sun-Diamond	0.2%	$278,354,000
5)	Sunkist	1.0%	$493,160,000
6)	Southern States Co-op	18.6%	$ 11,257,630
7)	Wisconsin Dairies	2.0%	$ 7,145,438
	AVERAGE TAX RATE	7.6%	

Part 2 Effective corporate taxation of cooperatives for 1983

1)	Agway	23.3%	$20,695,000
2)	Dairymen	1.7%	$ 6,234,000
3)	Landmark	32.4%	216,000
4)	Sun-Diamond	0.2%	$279,111,000

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5)	Southern States Co-op	23.9%	$ 3,992,259
6)	Wisconsin Dairies	2.0%	$ 8,711,712
7)	Goldkist	2.0%	$ 3,883,000
	AVERAGE TAX RATE	12.2	

A number of cooperatives had negative tax rates. While the special dividend deductions available to these co-ops help to reduce their tax obligations, they also had extensive investment tax credit, rapid amortization, or carryovers. These were not included in the analysis. Also, co-ops that showed a loss for either tax years were not included.

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Suggested Solutions

(1) Tax co-ops in the same manner as ordinary corporations This suggestion taxes all business corporations including cooperatives in the same manner and on the same basis. It makes cooperative corporations bear their fair share of the tax burden, and is the only solution that achieves total tax justice.

(2) Increase co-op cash payouts In order to ease the competitive advantage of cooperatives, NTEA suggests increasing the required cash payout (currently 20 percent) to at least 50 percent of cooperative patronage dividend distributions. This would result in greater competitive equality through a reduction in the cooperative pool of tax-free capital. Note this solution was suggested, and agreed to by the U.S. House of Representatives in 1969, but did not pass the Senate.

(3) Repeal of the corporate income tax on dividends distributed to shareholders Although this proposal would be a step towards co-op -- private investor corporate tax equality, it has several disadvantages, mainly political.

(4) Excise tax on cooperatives It would not be unconstitutional to levy on cooperatives an excise tax measured by their net income. For those who insist that cooperative corporations have no taxable income, an excise tax equal to the income tax for corporations might be the answer.

Although NTEA regularly advocates taxing the net margins of cooperatives in the same manner as ordinary corporate profits

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(suggestion #2), we believe that any of the above suggestions (suggestions #2-5) represent a step towards tax equality and certainly warrant Congressional consideration and investigation.

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STATEMENT OF DONALD A. RANDALL, EXECUTIVE VICE PRESIDENT AND GENERAL COUNSEL, NATIONAL INDEPENDENT DAIRY-FOODS ASSOCIATION, WASHINGTON, DC

Mr. RANDALL. Mr. Chairman, thank you for the opportunity to be here this morning. NIDA respectfully submits that this committee ought to consider the current substantial benefits that the cooperatives currently enjoy, their limited exemptions from taxes, and antitrust laws, and also through federally subsidized servicing and financing, and that no further tax exemptions are necessary or wise. We subscribe to the NTEA position almost totally. We would point out to the committee and urge that there is no evidence to this point that the farmer cooperatives are in such financial distress and that this one act alone would be a saving grace to restore them to a financially solvent position.

There are certainly some cooperatives that are in trouble. NEDCO and AGWAY and many others in the Northeast in your area are having some difficulties which we feel were brought upon themselves through very unwise management decisions, and we have suffered along with them. Our position is that we are seeking equity, equity between the cooperatives and the small independent dairy processors that we represent. Currently, the law provides for benefits and limitations when a business entity assumes the character of a corporation. Likewise, the law provides cooperative associations with specific benefits and specific limitations. In either case, benefits and limitations are inexorably linked. In asking that netting be permitted, the cooperative is in effect asking for the best of both possible worlds. At the same time, the cooperative wants to be permitted to offset income in one division with losses in another division; that is, utilizing the benefits of netting which is permitted for corporate entities. Yet, the cooperative intends to maintain its co-op dividend deductions. If a cooperative is to receive the benefits of this form of legal organization, it must concurrently exist within the limits of the cooperative. Co-ops should not be permitted to concurrently enjoy the benefits provided to corporations and the benefits of the cooperatives organizations. They, in effect, are already overbalanced with benefits that injure competition from the small dairy processors, and we have declined from over 7,000 in 1970 to about 1,000 today. If you look at the size of AGWAY, for instance, $3.7 billion last year, Land O 'Lakes, $3.2 billion, and others that are set forth in our statement, Farmland Industries with $4.6 billion in sales, airlines, insurance companies, refineries, oil pipelines, and other activities, which are used in competition with the taxpaying proprietary entities that we represent. We think that it is time for the Congress to take a careful look at the unbridled growth of these cooperatives and the incentives that they have and the lack of discipline that is upon them in making their marketing decisions. In the dairy industry, these cooperatives have been so favored with tax and other benefits, that they have gone out and built multimillion dollar and billion dollar facilities for processing milk, solely for the purpose of selling to the U.S. Government and not for the purpose of selling to a genuine market. Without the market disciplines, they are there filling a need that is not a true need and one that we feel needs to be carefully looked at by this

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Congress and by this committee. In this particular case, with the netting issue being an opening shot, we hope a careful review of their total tax structure will be an outcome of these hearings. We thank you very much, Mr. Chairman, for our opportunity to be here and ask that my complete statement with attachments be included in the record.

Senator CHAFEE. Thank you.

[The prepared written statement of Mr. Randall follows:]

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NATIONAL
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DAIRY-FOODS
ASSOCIATION
SINCE 1957

321 D STREET N.E. WASHINGTON, DC 20002 (202) 543-3838

STATEMENT OF

NATIONAL INDEPENDENT DAIRY-FOODS ASSOCIATION (NIDA)

BEFORE THE

U.S. SENATE COMMITTEE ON FINANCE

CONCERNING

AMENDMENT OF INTERNAL REVENUE CODE

July 15, 1985
Washington, DC

National Independent Dairy-Foods Association (NIDA) is a not-for-profit trade association of independent proprietary dairy processors, manufacturers and distributors. It is incorporated in the State of Delaware, and located at 321 D. Street, NE, Washington, D.C. NIDA has no national corporate members. Most members are small businesses.

All members of NIDA purchase fluid milk from independent dairy farmers and/or farmer-owned cooperatives. All of NIDA members compete with the processing, manufacturing or distributing divisions of large regional dairy cooperatives. Many NIDA members are supplied 50% or more of their fluid milk by the marketing divisions of dairy cooperatives and then our members compete with the processing units of the same associations for wholesale and/or retail accounts. These multimillion dollar

A merger of National Independent Dairies Association and National Association For Milk Marketing Reform

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cooperatives may have members and do business across many counties and states. They span whole regions of the country and entire federal market areas.

These supplier-competitors may be organized as a single cooperative with incorporated or unincorporated divisions or subsidiaries. They may be federations of autonomous cooperatives which can be totally involved in dairy or a conglomerate organization of marketing, service and supply units. Membership is often overlapping.

Dairy cooperatives dominate the supplies of fluid milk in the United States. Federal market order statistics for the 45 federal order areas show consistently over the years that cooperatives control between 75% and 85% of the fluid milk. In certain market areas, the control is a monopoly of 90 to 100% and in some places, large percentage shares are held by a single cooperative. (See attached copies of USDA Cooperative Service Statistics.)

The Congress has encouraged the growth of cooperatives through protective laws, exemptions and special priviledges beginning more than 70 years ago. The development of various cooperatives, in particular agricultural cooperatives, has been subsidized by various programs such as financial services. There are special banks to finance their activities. There is no doubt that this is a deep-rooted national policy. This policy has often collided with and damaged small and moderate-sized businesses which traditionally formed the backbone of our free

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enterprise system of proprietary companies providing services, handling and manufacturing in agriculture. The once considerable number of small independent dairies has been reduced ten-fold to probably less than 1,000 viable companies. Part of this reduction has been due to changing technology, marketing trends and economies of scale. But part of the loss of these free competitive, taxpaying businesses has been due to the federal government's cooperative policies.

Congress, through broad and generous grants of authority and funds, has encouraged agricultural cooperatives to expand from their more traditional role of assembling, marketing and processing commodities into a full range of services, supplies, manufacturing, wholesaling and retailing. It is reasonable to say that each time this expansion occurs, it does so at the loss of proprietary full taxpaying businesses.

NIDA RESPECTFULLY SUBMITS TO THIS COMMITTEE THAT COOPERATIVES CURRENTLY ENJOY SUBSTANTIAL BENEFITS FROM LIMITED EXEMPTIONS FROM TAXES AND ANTITRUST LAWS, AND ALSO THROUGH FEDERALLY SUBSIDIZED SERVICES AND FINANCING, AND NO FURTHER TAX EXEMPTIONS ARE NECESSARY OR WISE.

NIDA opposes the amendment of the Internal Revenue code as proposed to this Committee. The reasons are relatively simple and can be summarized as follows:

1. Farmer-ownud cooperatives are not all in financial distress and there is no evidence that without this amendment, either large numbers of cooperatives or their farmer members face

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financial distress. (See Fortune 500 lists of Manufacturing and Service Cooperatives.)

2. Farmer-owned cooperatives currently enjoy substantial advantages over taxpaying proprietary companies. (See (1981) Dialog of one independent dairy company which lists fifteen advantages from its perspective.)

3. The Capper-Volstead Act (7 U.S.C 291-2) confers substantial advantages of partial exemption from antitrust, such as unlimited price fixing among members and possibly even federations of cooperatives, and enrollment of 100% of all farmers in a single supply controlling and price fixing monopoly (according to the U. S. Attorney General).

4. Cooperatives operate within federal and state cooperative enabling or qualifying statutes such as the Capper-Volstead Act. They are legal entities with special priviledges and obligations which separates them from ordinary state chartered business corporations. The tax treatment and equity consideration among patrons and members requires distinct treatment for netting gains and losses under the Internal Revenue Code.

5. Patrons and members of cooperatives are different from stockholders in ordinary business corporations and receive special tax consideration.

6. There is no equitable method by which losses and gains can or should be netted between federated cooperatives or even cooperative divisions where membership differs and changes regularly, and where such cooperatives are engaged in diverse

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functions of supply (non-Capper-Volstead exempt) and marketing (Capper-Volstead qualified).

The amendment is unnecessary, and would be detrimental to proprietary full taxpaying independent dairies. The Congress should examine and repeal or modify all laws, including the Capper-Volstead Act, and other special advantage statutes before making additional changes to the Internal Revenue Code. If cooperatives were treated as ordinary business corporations in all respects, including antitrust, then there would be no need for this amendment.

Thank you for your time and consideration.

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Figure 3: Cooperatives share of milk marketed based on farm location and grade, and total milk marketed, by regions, 1980.[1]

Pacific

	Grade A	Mfg Grade
Total (bil. lbs.)	18.5	0.6
Co-op Share (%)	57	46

Mountain

	Grade A	Mfg Grade
Total (bil. lbs.)	4.5	1.4
Co-op Share (%)	87	37

West North Central

	Grade A	Mfg Grade
Total (bil. lbs.)	12.8	8.6
Co-op Share (%)	92	71

West South Central

	Grade A	Mfg Grade
Total (bil. lbs.)	6.1	0.2
Co-op Share (%)	85	*

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East North Central

	Grade A	Mfg Grade
Total (bil. lbs.)	28.0	1.6
Co-op Share (%)	93	53

New England

	Grade A	Mfg Grade
Total (bil. lbs.)	4.4	—
Co-op Share (%)	82	—

Middle Atlantic

	Grade A	Mfg Grade
Total (bil. lbs.)	19.0	0.1
Co-op Share (%)	62	87

East South Central

	Grade A	Mfg Grade
Total (bil. lbs.)	5.0	0.7
Co-op Share (%)	84	12

South Atlantic

	Grade A	Mfg Grade
Total (bil. lbs.)	9.1	0.2
Co-op Share (%)	81	*

[1]Regions based on location of operators farms.
*Not shown to avoid disclosing individual cooperative operations.

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MILK RECEIPTS AND UTILIZATION

In 1980 cooperatives received or bargained for 95.6 billion pounds of milk (net of intercooperative transfers), or almost 77 percent of total volume sold by farmers to the Nation's plants and dealers (table 3). Cooperatives' share of this volume increased by slightly less than 1 percent between 1973 and 1980, representing a leveling out of the longer term trend toward an increased cooperative market share. In line with the Nation's increasing milk production, the volume marketed by cooperatives increased 15 percent in the period.

Cooperatives' share of the market varied considerably by region, based on their headquarter locations (fig. 2).

The Central Region, with the largest number of dairy cooperatives, had 64 percent of total U.S. cooperative milk volume in 1980, down from 65 percent in 1973. Between 1973 and 1980 the volume of milk marketed by cooperatives headquartered in the region increased from 54.3 billion pounds to 61.2 billion pounds. The cooperative's share of all milk sold to plants and dealers in this region continued a steady increase, from 85 percent in 1973 to 89 percent in 1980.

An earlier trend to lower cooperative volume and cooperative share in New England was sharply reversed in the 1973-80 period. In 1980, cooperatives headquartered in the region sold 4.3 billion pounds of milk to plants and dealers. This represented 99 percent of the total poundage.

Cooperative volume and the cooperative share of all milk declined in the Middle Atlantic Region. In addition, the cooperative share of milk marketed in the Mountain Region declined slightly, although cooperative volume increased.

Cooperative volume and the cooperative share of all milk marketed increased in all other regions, with a significant increase in the Pacific Region.

Supply, Location, and Grade

Almost 32 percent of total milk received directly from producers and marketed by cooperatives came from farms in the East North Central Region (table 4 and fig. 3), a slight increase over the percentage in 1973. Farms in the West North Central and Middle Atlantic Regions supplied 19 and 13 percent, respectively, of the total cooperative supply, a slight decline

Figure 2: Total milk sold to plants and dealers and cooperative's share of total by geographic regions, 1980. (Billion pounds)

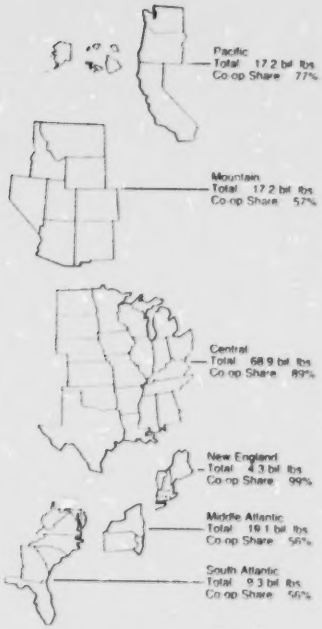

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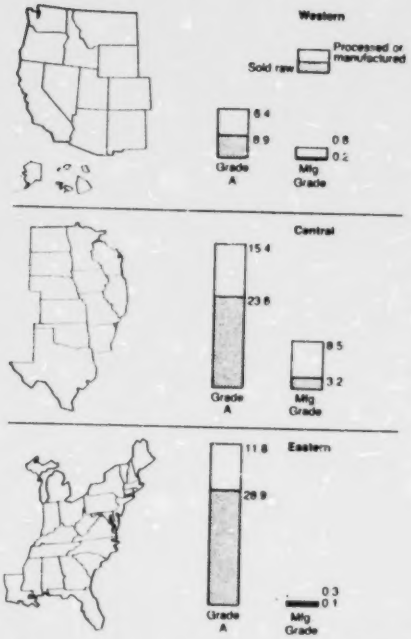
Figure 4: Utilization of cooperatively marketed Grade A and Manufacturing Grade milk, by regions, 1980. (Billion pounds)



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from the previous survey. Just over 91 percent of the supply of cooperatives' manufacturing grade milk came from farms in the two North Central Regions—55 percent from the West North Central Region and 36 percent from the East North Central Region.

Reflecting the continuing conversion from manufacturing grade milk to grade A production and the generally increased production of grade A milk, cooperatives marketed about 21 percent more grade A milk for their member-producers and about 18 percent less manufacturing grade milk in 1980 than in 1973.

The 420 cooperatives that marketed milk for individual farmer members represented 97 percent of all dairy cooperatives, with the other 15 being federations of cooperatives. Some 322 cooperatives marketed grade A milk for farmer-members and 228 marketed manufacturing grade. In 1980, their direct marketings of grade A milk for these producers totaled 83.3 billion pounds or a market share of 79 percent of all grade A milk, a slight drop from the 81-percent share in 1973. In the same year, cooperatives marketed 11.1 billion pounds of milk of manufacturing grade, a slight increase of from 55 to 57 percent.

The proportion of grade A milk marketed by cooperatives varied from 93 percent in the Pacific Region to 93 percent in the East North Central Region. From 1973 to 1980 significant increases in quantities marketed and in cooperative share of grade A marketings were found in the New England (19 point share increase and 42 percent more grade A milk) and Mountain (10 point share increase and 49 percent increase in quantity) Regions. On the other hand, the Middle Atlantic Region lost 14 market share points and 5 percent of the cooperative volume of grade A milk. However, this region did have an increase in both cooperative market share and quantity marketed of the small amount of manufacturing grade milk produced in the region.

Supply by Source

In 1980, nearly 88 percent of the 107.9 billion pounds of milk received by dairy cooperatives came directly from farmers, up from 84 percent in 1973 (table 5). Most of the remainder came from other cooperatives. Cooperatives in the Central Region received more than 91 percent of their milk directly from producers, whereas in the Western Region cooperatives received only 84 percent of their milk directly from producers (see fig. 4 for makeup of regions). In 1980, 332 cooperatives received 94.9 billion pounds of grade A milk from all sources. There were 230 cooperatives that received

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Co-ops Un*Fortune*ately Lose Ground on '500' List

A special report in the April *Fortune* magazine is titled "Ten Years that Shook the Fortune 500." The headline statement comes as no surprise to the biggest cooperatives on that list. They were still feeling the shock in 1983.

Ten cooperatives are on the list, the most in its history (table 1). Some bigger ones aren't there by definition or other reasons. But indications that agriculture and consequently cooperatives are lagging the business turnaround is that seven of nine cooperatives on earlier lists lost ground with their 1983 sales. In fact, six of the cooperatives registered lower sales in 1983 than in 1982.

Michigan Milk Producers' Association was the newcomer to the list. Cooperatives increasing sales were Mid-America Dairymen, Inc., Sun-Diamond Growers of California, and Wisconsin Dairies. Cooperatives continued to make the "Ten Best" lists in three categories. National Cooperative Refinery Association was second in sales per employee with $1,418,372 and fifth in assets per employee with $722,376. Michigan Milk Producers Association was fourth in sales per dollar of stockholders' equity with $22.31.

Table 1—Cooperatives on 1984 Fortune '500' list of industrial corporations

Cooperative	Sales	1981	1982	1983
	Thous. Dol.	*Ranking on List*		
Agway	3,768,212	100	97	98
Land O'Lakes	3,264,792	115	100	121
Gold Kist Inc.	1,481,424	212	230	238
CENEX	1,409,085	265	234	243
Mid-America Dairymen	1,386,822	263	253	247
CF Industries	982,048	303	311	328
National Cooperative Refinery Assn.	784,380	374	331	348
Michigan Milk Producers' Assn.	582,038	*	*	430
Sun-Diamond Growers of California	522,199	*	443	447
Wisconsin Dairies	447,555	*	486	480
Total	14,573,978			

*Not listed in year shown.

Nine Co-ops Make *Fortune* 'Service 100'

Fortune magazine's 1984 list of the largest 100 diversified service companies includes 9 cooperatives, one more than the previous year's list. The list is based on financial data for fiscal years that ended in 1983. (The ranking of nine additional agricultural cooperatives in the traditional *Fortune* 500 listing of top industrial and manufacturing corporations was carried in June 1984 issue of *Farmer Cooperatives*.)

Generally, cooperatives ranked higher on the list according to sales. Cooperatives were near the bottom of the list in assets and stockholders' equity, except for Farmland Industries, which ranked 19th and 25th, respectively.

However, cooperatives as a group were operating with fewer employees. The highest ranking of any cooperative was also Farmland, which ranked 44th. The other eight were near the bottom of the top 100. Following are the cooperatives' ranking in the 1984 list compared with the previous year's list.

Table 1—Cooperatives in *Fortune* Service 100' List

Cooperative	Sales	1983	1984
	1,000 Dol.	*Ranking on list*	
Farmland Industries, Inc.	4,888,893	9	8
Associated Milk Producers, Inc.	2,899,730	15	17
Harvest States Cooperative, Inc.	2,355,443	21	19
AGRI Industries, Inc.	1,414,788	39	40
Dairymen, Inc.	1,186,699	50	47
Indiana Farm Bureau Cooperative Assn.	1,073,433	*	54
Landmark, Inc.	655,579	81	80
Southern States Cooperative, Inc.	642,259	76	82
Sunkist Growers, Inc.	632,631	77	85

*Not listed.

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Dialog
an exchange of information and ideas

Special Dialog
May 21, 1981

Question: Recently it was announced that _____ Dairies had a large milk customer in Lancaster Valley Farms because the price was lower. Given the desire to raise wholesale milk prices, is there any way to maintain or even a financial problem, how can we stay such milk [illegible] and still be able to run their business?

Response: Federal and state laws and regulations give dairy cooperatives in Pennsylvania numerous advantages in the areas of taxation, legal requirements, etc., which proprietary companies like ours do not have. As a result, private companies have been going out of business while milk farmers' cooperatives have been expanding into the processing area.

Let's compare a private company with a cooperative: *

	COOPERATIVE	PRIVATE COMPANY
Federal income taxes	Exempt (partial)	46% of profits
State income tax	9% of profit	9% of profit
PA. capital stock tax	None	1%
Sales and use tax: Vehicles All other	6% Exempt	6% Exempt on dairy processing equipment only
Unemployment Compensation	Exempt	2.5% on first $8,000 (PA) 3% on first $6,000 (Federal)
Farmers' equity and	Not available	Other avl. on mkt. or a bond
Long term bonds	Make for cheaper lower interest rates	Commercial banks--prime rates
Payment of interest	Can be received	Not pay
Amount of loans	Make for higher loans effective	Subject to statements of fin. stat. statements and profit record
General [illegible] Advertising with milk producers	Can't make purchase of members or any service and products	Can buy advertising
Membership in [illegible]		

* NCDA does not endorse all assumptions of this dairy comparison. Clarifications are necessary.

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	COOPERATIVE	PRIVATE COMPANY
Financial losses	Assesses members through deductions from milk checks	Sustains losses, or goes out of business
Price of milk paid farmers	By averaging all purchases, can pay less than full classified prices	Must pay full classified prices
Penalty for late payment of milk receipts	No penalty	1% of balance due per month
Antitrust laws	Exempt from restrictions in mergers, and permitted to fix prices as well as charge premiums	Strict enforcement of antitrust laws
Dividends to stockholders	None	Must pay return on investment or lose investors

So you see, more than just wages are involved in the cost of a product and the competition to sell it.

If any of our employees are interested in reading more about the comparison of private companies with operations by a cooperative, a series of articles published by the Louisville, Kentucky, Courier is available in our Public Relations Office.

President

kse
Posted: All Locations
Remove: July 28, 1981

cc: Full Management Roster

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Senator CHAFEE. I must say that I looked at that chart that was attached to Mr. Delaney's statement about the size of these co-ops. Farmland industries, $5.6 billion; AGWAY, $3.7; Land O' Lakes, $3.2 billion; Gold Kist, $1.4 billion; Farmers Union Central Exchange, $1.4 billion; Grain Terminal Association, $2.3 billion; Associated Milk Producers, $2.6 billion. These aren't exactly little outfits, are they?

Mr. RANDALL. No, sir; they are not, and they are devastating in the sense that, in dairy, they control in many markets over 90 percent of the available milk and then compete against us as a market competitor in selling that same product after they have assessed overorder premiums and engaged in other activities which are supply-restricting activities, in order to enhance the price of the product and to put us at a competitive disadvantage. We are crying out for equity and for some relief; and that is to put the cooperatives on an equal footing with the corporations.

Senator CHAFEE. What is the principal advantage you think they get? One you mentioned was the financing. OK. Where they receive their financing from. Right?

Mr. RANDALL. Yes, sir.

Senator CHAFEE. Two, that they are not in effect taxed twice on dividends.

Mr. RANDALL. That is correct, too.

Mr. DELANEY. And one of the things that we think is an inherent evil in this system is that they tend to give the farmer producer chits rather than paying cash dividends back to him, and I think that that, in some of the cases where corporate decisions are made by the cooperatives, they pass back these chits that are never going to be honored or don't appear to be honored until you reach 80, if you do, in many cases.

Senator CHAFEE. Now, wait, that is a separate thing. Now, you are saying that the farmer who belongs to these things is duped. Well, I think people are pretty smart. When it comes to people's money, they are usually pretty smart. I doubt if they think they are duped.

Mr. RANDALL. Well, there is a large group——

Senator CHAFEE. I think if you are going to make your case, I wouldn't make it on the fact that you are here before us in order to give justice to the members of the co-ops. I think they feel they are getting justice. They don't need you at bat for them in there. You are really trying to make your own case. Your own case is that it is unfair?

Mr. RANDALL. Yes, sir.

Senator CHAFEE. I would stick to that line of argument, more than coming in as the protector of the poor farmer.

Mr. RANDALL. I would say that we have been meeting with farmers in the Northeast, and there are about 7,000 who are not in the cooperatives up there who are very interested in having a voice in Congress. We have been asking them to organize themselves, and we are helping them to get organized so that they can have some spokesmen here, other than just the cooperatives. And in fact, USDA has just this year for the first time gone out with polls and asked to hear from the independent farmers. We think it is high

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time that that large group be heard from, and I hope that we can speak for them. We can't survive without them.

Mr. DELANEY. Mr. Chairman.

Senator CHAFEE. Yes?

Mr. DELANEY. If I may, I have one additional point on the issue of the patronage dividends that are distributed as allocated certficates. I think there is a point to be made about the Government encouraging the use of a certificate dividend rather than a cash dividend by allowing a tax deduction for the certificate allocation. I realize redemption policies of the cooperative are run through the board of the cooperative, but is it in the interest of the individual farmer to receive a certificate dividend with some date in the future for redemption? And is that something that should be encouraged by Government tax policy?

Senator CHAFEE. What do they do with that certificate?

Mr. DELANEY. The farmer or the cooperative?

Senator CHAFEE. The farmer when he gets it.

Mr. DELANEY. He holds the certificate until such time as it can be redeemed by the cooperative, whatever the——

Senator CHAFEE. Can you use it to get credit from the bank?

Mr. DELANEY. I believe so. I am not sure.

Senator CHAFEE. All right. Can he use it at the co-op to purchase supplies?

Mr. DELANEY. I don't believe so.

Senator CHAFEE. All right. Thank you very much, gentlemen. I appreciate your coming. Next, we have Mr. James Krzyminski, vice president and general counsel of the National Council of Farmer Cooperatives; and Mr. Fulton, general counsel and secretary of Welch Foods, Inc.

STATEMENT OF JAMES KRZYMINSKI, VICE PRESIDENT AND GENERAL COUNSEL, NATIONAL COUNCIL OF FARMER COOPERATIVES, WASHINGTON, DC

Mr. KRZYMINSKI. Thank you, Mr. Chairman. We very much appreciate your efforts in scheduling this hearing to consider the cooperative netting of losses issue.

Senator CHAFEE. Did I pronounce your name right?

Mr. KRZYMINSKI. Yes, sir.

Senator CHAFEE. Do you have any trouble with that over the telephone?

Mr. KRZYMINSKI. Always.

Senator CHAFEE. I think I have trouble with Chafee. Go Ahead.

Mr. KRZYMINSKI. Mr. Chairman, I will be very brief in summarizing my written testimony. I have Mr. Thomas Mulligan on my left, and Mr. Clifford Fulton on my right to assist me in answering any questions you may have. Mr. Mulligan is vice president for finance for Growmark, Inc., headquartered in Bloomington, IL; and Mr. Fulton is the general counsel for Welch Foods, Inc., headquartered in Concord, MA.

We support Senator Mattingly's efforts to seek a legislative reaffirmation of cooperatives' right to offset gains and losses among their purchasing and marketing departments for purposes of computing net earnings available for distribution to patrons. Both Mr.

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Delaney and Mr. Randall characterized Senator Mattingly's amendment as a new tax benefit for cooperatives, but we don't believe that to be the case. We think it is merely a reaffirmation of what the code already says and what the courts, including the Tax Court, have already affirmed. As you have seen from the cases that have been cited so far, the courts have consistently confirmed this right. In addition, the U.S. Department of Agriculture has strongly advocated the need for cooperatives to net gains and losses. They need to do this for their economic survival, and nothing in subchapter (t) prohibits them from doing so. Indeed, section 1388(a) specifically refers to the net earnings of the organization in defining amounts that may be paid to patrons as patronage dividends. It does not refer to net earnings of separate departments or divisions.

No tax avoidance results from netting gains and losses because such decisions are merely matters involving allocations among the members of the cooperative. A single tax is paid, as intended by subchapter (t), regardless of which patrons receive the allocations.

Although the netting issue has been under administrative consideration for nearly 20 years, the Technical Advice Memorandum issued last January by the National Office of IRS stimulated the board of directors of the National Council of Farmer Cooperatives to unanimously adopt a resolution calling for a legislative solution to the problem. The concern they expressed was the cost and the business uncertainty with continuing litigation. We believe the Service, with its unlimited resources, may keep litigating the netting issue even if cooperatives continue to win in court, as we fully expect they will. However, cooperatives do not have unlimited resources, particularly when we are talking about money that would otherwise be going to their farmer patrons.

Considering all the factors; namely, first that netting is contemplated under section 1388(a) of subchapter (t); second, that netting is revenue neutral; third, that the U.S Department of Agriculture has consistently advised the IRS that its view of netting is incorrect; fourth, that the courts, including the Tax Court, have done likewise; and fifth, that it would be unfair to require cooperatives to continue to litigate, we believe this subcommittee should favorably report out language along the lines proposed by Senator Mattingly.

One comment I would like to make before concluding, Mr. Chairman, is in response to a statement that Mr. Mentz made concerning the fact that Treasury will continue to explore, in cooperation with the USDA and the cooperative industry, the feasibility of establishing administrative guidelines in this area. The fact is that Treasury and the Internal Revenue Service have had this issue under review for nearly 20 years. And even though the courts have consistently held that cooperatives may net their gains and losses for the purpose of determining their net earnings, Treasury and the IRS have continued to ignore these findings or to reflect those decisions in promulgating any administrative guidelines. For these reasons, legislation is necessary to clarify once and for all the tax treatment of cooperatives with regard to netting. Again, Mr. Chairman, we appreciate very much this opportunity to appear before you today, and we will be pleased to try to answer any questions that you may have.

[The prepared written statement of Mr. Krzyminski follows:]

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National
Council of
Farmer
Cooperatives

Statement Of The

National Council of Farmer Cooperatives

Before The Subcommittee On

Taxation And Debt Management Of The

Senate Committee On Finance

July 15, 1985

By

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Serving America's Family Farmers

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SUMMARY

The National Council of Farmer Cooperatives has a vital interest in the cooperative netting of losses issue.

Netting of gains and losses within and among various departments is critical to the economic survival of many cooperatives, and is a common practice engaged in by cooperatives over a period of many years.

The Internal Revenue Service has challenged cooperatives' right to net on the basis that netting results in an inequitable allocation of earnings among cooperative members. Cooperatives believe that netting decisions should be left to the members and their duly elected representatives, the board of directors, and that netting is entirely consistent with the tax treatment afforded cooperatives under Subchapter T of the Internal Revenue Code. The U.S. Department of Agriculture strongly concurs in these views.

The courts have consistently disagreed with the IRS on the netting issue. The Tax Court, in particular, has used unusually harsh language in rebuking the IRS challenge of a cooperative's right to a net operating loss carryover, calling it "...conceptually strained and lacking any fundamental policy support; in short, as unwarranted tinkering with the tax structure applicable to cooperatives." Associated Milk Producers, Inc. v. Commissioner, 68 T.C. 729 (1977). Later Tax Court cases have reaffirmed that the allocation of losses among a cooperative's present, continuing, and future members is properly the concern of the members and the board of directors.

Unless Congress reaffirms cooperatives' right to net the gains and losses of their various departments, needless and expensive litigation will continue. Accordingly, the National Council strongly supports the amendment proposed by Senator Mattingly to confirm the right of cooperatives, already contained in Subchapter T, to combine gains and losses of their various departments for purposes of determining net earnings from business done with or for patrons.

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Introduction And Background

Mr. Chairman and members of the Subcommittee, my name is James Krzyminski. I am Vice President and General Counsel of the National Council of Farmer Cooperatives. The National Council is a nationwide association of cooperative businesses which are owned and controlled by farmers. Its membership includes 104 major marketing and farm supply cooperatives, the 37 banks of the cooperative Farm Credit System, and 33 state councils of farmer cooperatives. National Council members handle practically every type of agricultural commodity produced in the United States, market these commodities domestically and around the world, and furnish production supplies and credit to their farmer members and patrons. Five out of six U.S. farmers are affiliated with one or more cooperatives. The National Council represents about 90 percent of the nearly 6,000 local farmer cooperatives in the nation, with a combined membership of nearly two million farmers.

With me today are Thomas E. Mulligan, Senior Vice President - Finance, GROWMARK, Inc., Bloomington, Illinois and Clifford R. Fulton, Vice President, General Counsel and Secretary of Welch Foods, Inc., Concord, Massachusetts. These gentlemen are members of the National Council's ad hoc subcommittee on netting. In addition, Mr. Mulligan serves as subcommittee chairman. The ad hoc subcommittee consists of 35 professional advisors to cooperatives. It was formed many years ago as a result of indications by the Internal Revenue Service that it did not believe cooperatives should be allowed to net gains and losses within or among their various divisions or departments.

The ability to net is essential to the economic survival of many cooperatives. Indeed, netting has been utilized by farmer cooperatives for more than 80 years in an effort to spread the risks of production for the mutual benefit of their members. This sharing of risk is fundamental to the very nature of cooperation.

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For nearly 20 years the National Office of IRS has had the netting of losses issue under consideration. During that time the National Council has met with Treasury and IRS officials on several occasions and submitted memoranda to the Treasury Department and the Internal Revenue Service in support of cooperatives' right to net. The U.S. Department of Agriculture has strongly supported cooperatives on this issue. In 1980, the Department prepared a 56-page analysis of the netting issue firmly supporting cooperatives right to net across departmental lines. The analysis was in response to an IRS Memorandum challenging this right. Ironically, the IkS had earlier proposed a rule in 1968 that would have required cooperatives to offset losses against gains in calculating net margins allocated to patrons. USDA opposed that proposal as well on the grounds that the law permits cooperatives and their patrons to determine their own patronage refund policies.

In January of this year the National Office of IRS issued a technical advice memorandum stating that netting is not permitted except in certain limited circumstances. The memorandum also held that the pre-existing legal obligation requirement, which is essential for the issuance of patronage dividends, is not met where the cooperative's board of directors has discretion to net the gains and losses of various departments or divisions.

Following the issuance of the technical advice memorandum, the ad hoc subcommittee on netting unanimously approved a resolution calling for a legislative solution to the netting issue. The resolution later was unanimously adopted by the National Council's board of directors. Accordingly, the National Council supports Senator Mattingly's amendment, which we believe simply reaffirms the existing right of cooperative's to net.

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Requirements Of Subchapter T

Subchapter T applies with certain exceptions to any corporation operating on a cooperative basis. The deduction for payment of patronage dividends is an essential part of the tax treatment intended by Subchapter T, that is, a single tax on net patronage earnings to be paid either by the cooperative or by its patrons. Organizations that qualify under Subchapter T must pay ordinary corporate tax on any income that is not based on patronage or which is not returned or allocated to patrons. However, Subchapter T permits cooperatives to deduct patronage refunds from their net earnings on patronage business before paying taxes. To the extent that patronage refunds are deductible by the cooperative, they are treated as income to its patrons. Thus, Subchapter T assures that a single tax will be paid on all patronage-sourced net margins. Of course, margins attributable to non-patronage business fall outside the scope of Subchapter T, and are taxed as ordinary corporate profits.

The term "operating on a cooperative basis" is not defined in Subchapter T. The crux of the disagreement between the cooperative industry and the IRS centers on the question of whether netting destroys the requirement of "operating on a cooperative basis."

For many years, organizations which have been organized and operated to conduct business with patrons without entrepeneurial profit to themselves, and which have had an obligation to distribute their net earnings from patronage business on the basis of the quantity or value of business done with or for patrons, have been recognized as operating on a cooperative basis and allowed to deduct their patronage dividend distributions. Under the IRS theory, the cooperative would be broken up into multiple entities for tax purposes. For example, a cooperative with six departments or divisions would be required to

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treat each as a separate entity for tax purposes. Subchapter T does not require this result.

Reasons Why Cooperatives Net

Netting decisions are not motivated by tax considerations. Regardless of which patrons receive them, Subchapter T affords single tax treatment to qualified patronage refunds. Netting is simply an allocation decision made by the members through their duly elected board of directors for non-tax business reasons. The board of directors is responsible to the members. Whether or not to net is an internal decision for the board and the members, not the IRS.

Where a cooperative performs more than one service for its members, such as marketing more than one product, or engaging in both marketing and supply activities, it nevertheless functions as one entity for tax purposes.

Section 1388(a) defines a patronage dividend as an amount paid by an organization to a patron (1) on the basis of quantity or value of business done with or for such patron, (2) under an obligation to pay such amount, which obligation existed before the organization received the amount so paid, and (3) which is determined by reference to the net earnings of the organization from business done with or for its patrons.

Thus, where a cooperative has a pre-existing obligation to pay its net earnings to patrons on the basis of the quantity or value of business done with or for such patrons, the requirements of Section 1388(a) are met. The IRS should not be permitted to further define Section 1388(a) by reading into the law a theory requiring a multi-faceted cooperative to become multiple entities for tax purposes.

Furthermore, under the IRS multiple entity theory, a cooperative could have an overall net loss in a given year on its patronage business and yet still have a tax liability merely because some of its patronage departments or

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divisions were profitable. Such a result is contrary to the intent of the Internal Revenue Code.

Why Does The IRS Object To Netting

The IRS takes the position that netting of gains and losses among divisions or departments within a cooperative results in "inequitable allocation" of patronage refunds, and that where the board of directors has discretion in netting decisions the pre-existing obligation under Section 1388(a) to return patronage refunds is destroyed.

The industry's position is that netting does not result in "inequitable allocation", and that rigid IRS rules are not a proper substitute for the members' own decisions concerning what is equitable. Indeed, decisions regarding netting are not conducive to rigid rules. They vary among cooperatives under a wide range of circumstances. Netting decisions are normally made at the end of the year when all of the results of the various activities within the cooperative are known. The IRS has expressed concern that some patrons may not be treated fairly or equitably if the cooperative is allowed to net at year end.

It must be remembered that cooperatives are subject to the control of their members and that the directors have fiduciary duties to act in good faith in carrying out their responsibilities on behalf of the membership. If these duties are somehow breached because of netting (the IRS has never identified a breach of duty situation during all the years of discussion on the issue), the members have the right to mount a legal challenge. Furthermore, the members adopt and amend the bylaws. If the members choose to delegate discretionary duties to the board, there is no reason to presume that they lack sufficient power to control netting decisions.

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The timing aspect of netting decisions also seems to concern the IRS. At past meetings with industry representatives it has been suggested that netting might be permissible provided all decisions regarding netting be made before the start of the cooperative's fiscal year. This view ignores the unpredictability of agriculture.

When the farmer plants his crop he has the hope but not the assurance of a profitable harvest. In any given year he may make money in one commodity and lose it in another. The reverse may be true the following year.

As an extension of the farmer's marketing operation, his cooperative faces the same economic uncertainty. The results are known only at the end of the year. It is unrealistic to expect the board to make netting decisions in a vacuum at the beginning of the year when none of the facts are known.

The IRS also argues that netting somehow creates the potential for tax abuse. However, throughout all the years of meetings and discussions between the industry and the IRS, no concrete examples of tax abuse resulting from netting have been alleged.

A hypothetical situation often raised by the Service deals with the concern that normal corporate profits of a cooperative might be improperly converted to deductible patronage dividends by netting patronage losses and non-patronage income through the netting process. However, an Eighth Circuit decision[1] handed down in 1980 explicitly prohibits such netting by non-exempt cooperatives . The IRS does not need a rigid no-netting rule to prevent such practices.

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1 Farm Service Cooperative v. Commissioner, 719 F.2d 718

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Another hypothetical situation raised by the Service questions whether an organization can ever be said to be "operating on a cooperative basis" if the profits from one group of patrons are used to subsidize losses of another group of patrons, beyond mere start-up losses. (Which the Service seems to concede might be appropriate for netting purposes.)

As long as a profit motive exists, the members of the cooperative should retain the right to determine the extent to which they will net gains and losses among themselves. One of the major reasons for cooperation is economic survival through sharing of risk. A department that sustains losses nevertheless contributes to the cooperative's overhead, and may, in the eyes of the board of directors, hold the potential for future profits.

Cooperative business practices having a legitimate purpose should not be prohibited where no tax abuse results. Somewhere in its consideration of the netting issue the IRS has lost sight of the business purpose of cooperatives, namely to enhance returns to their members, not to create losses. There is simply no incentive to do so.

The Courts Have Consistently Disagreed With The IRS On The "Equitable Allocation" Issue

The "equitable allocation" issue has been litigated in numerous cases, and the courts have consistently rebuffed the IRS intrusion into cooperatives' internal allocations of net earnings among patrons of various departments. For example, in Pomeroy Cooperative Gin Company v. Comm'r, 288 F.2d 326, (8th Cir. 1961), a case decided before enactment of Subchapter T, the court found that patronage dividends, to be deductible, must be distributed equitably. However, the court also noted that the question of equity was within the sound discretion of the directors of the cooperative. The court questioned the Commissioner's legal standing to attack the distribution method of the cooperative.

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> "From a revenue standpoint, the Commissioner should be more concerned with the total exclusions allowable on membership business profits rather than the means by which such profits are divided among the qualified members. As stated in the Birmingham case at page 213 of 86 F.Supp., 'the crucial question involved in determining the taxability of patronage dividends is whether they constitute income to the cooperative, or to the patron, or to both.'" (288 F.2d at 333. Emphasis added).

Congress elected not to enact into law as part of Subchapter T any requirement of equitable distribution other than that expressly contained in the Section 1388(a) definition of a patronage dividend.

The Court of Appeals for the 9th Circuit also rejected a similar attempt by the Commissioner to determine the tax status of a mutual organization by reference to his concept of fairness among its members. In Peninsula Light Co., Inc. v. U.S., 552 F.2d 878 (9th Cir., 1977), the Commissioner attempted to revoke the taxpayer's determination of exemption under Section 501(c)(12), as a mutual or cooperative electric company, because certain members thereof received distributions in exchange for their membership in amounts less then they would have received had the distributions been made on a patronage basis. The court held that while the Code requires Section 501(c)(12) organizations to operate without a profit motive, it does not require any particular system of distribution of profits to members. The court noted:

> "We, as an appellate court, are not here to decide what is most 'fair' for the members of Peninsula and we seriously question whether that is properly within the province of the IRS either. We sit only to decide whether Peninsula is a tax-exempt mutual organization. Even assuming that Peninsula's system is unfair to some members, it is the members themselves, using their equal voting power, who should change it, if that is their wish and if they can muster the strength." (552 F2d at 881-2.)

Another example of the Service's undue concern with cooperatives' internal allocations among members is Associated Milk Producers, Inc., 68 T.C.

729 (1977). That case involved a challenge to the cooperative's right to a net operating loss carryover. In rejecting the challenge, the court stated.

> "We consider respondent's position herein not only contrary to the express provisions of Section 172, but conceptually strained and lacking any fundamental policy support; in short, an unwarranted tinkering with the tax structure applicable to cooperatives."
>
> * * * *
>
> "We fail to see any legitimate interest of respondent in the mechanics of petitioner's allocation of losses among its past, current, or future member-patrons. (Citations omitted)

In Lamesa Cooperative Gin v. Commissioner, 78 T.C. 894 (1982) the cooperative sold equipment in 1974 on which it had deducted depreciation in prior years. The gain from the sale of the equipment was reported on the cooperative's taxable year 1974 return as ordinary income. In determining the amount to be paid as patronage dividends, the cooperative allocated all the gain to its taxable year 1974 patrons in proportion to their patronage during that year.

The cooperative based its allocation of patronage dividends for taxable year 1974 solely on the patronage of its marketing operation even though it also conducted a small purchasing function. In considering the Commissioner's claim that the patronage dividend deduction should be disallowed the Tax Court held:

> "Boards of directors of cooperatives do not have carte blanche to make whatever allocations they choose, but we believe (the Commissioner) should recognize that directors have some discretion, some flexibility, in the exercise of business judgment. Only when unreasonable exercise of that discretion appears should the board's weighing of the equities be overturned by this Court."
>
> * * *
>
> "In determining whether (the Commissioner) erred by disallowing the patronage dividend deduction that it attributed to gains from the purchasing function, our inquiry should simply be whether the allocation was inequitable in view of the board of director's consideration discretion."
>
> * * *

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> "In summary, we find that the patronage dividend allocations made by (taxpayer) with respect to both the gain from the sale of the equipment in taxable year 1974 and with respect to any gain it might have derived from its supplies purchasing function were not inequitable. This is not to say that the particular method of allocation employed by (taxpayer) would have been the only proper way of allocating these gains. We hold merely that petitioner's board of directors did not unjustly discriminate against one group of patrons at the expense of another group, given the practicalities of the allocation, the substantial similarity in the identity of patrons over the years, the absence of any indication that any of the patrons complained about such allocations, and, with respect to the profit from the purchase and resale of supplies, the de minimus nature of the item."

In 1980 the Tax Court decided Ford-Iroquois FS, Inc. v. Commissioner, 74 T.C. 1213. There the cooperative incurred net operating losses during 1971 and 1972. Its board of directors elected to carry the losses forward, effectively offsetting losses from the grain and supply departments against 1973 supply department income. Some of the losses were attributable to members who terminated their membership in the cooperative prior to 1973. The bylaws were silent on the treatment of losses but granted the board broad management discretion. The Tax Court held:

> "Given the relevant articles of incorporation and bylaws, the considered business judgment of the board of directors, the apparent approval of the members, the actual allocations, and the language of the state law concerning cooperative member-debt liability, we hold that (taxpayer) is entitled to carry forward that part of its grain and farm supply losses allocable to terminated members."
>
> * * * *
>
> "The allocation of losses among a cooperative's present, continuing and future members is properly the concern of the membership and its board of directors."
>
> * * * *
>
> "(Taxpayer) chose to carry forward the net operating losses rather than attempt to recover such amounts from terminated members. This was a business judgment."

The most recent court decision dealing with the issue of "equitable allocation" is Kingfisher Cooperative Elevator Association v. Commissioner, 84

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T.C. No. 39, filed April 2, 1985. In that case the taxpayer, a local farmer cooperative, included patronage dividends received from regional cooperatives of which it was a member in its gross income in the year of receipt. In computing its patronage dividends, the cooperative allocated net income according to the patronage of its member-patrons during that year. This allocation method was adopted by the cooperative's board of directors and ratified annually by the members. The Tax Court held that the allocation method was equitable considering the stability of the cooperative's membership, the practicalities of the allocation, and the apparent approval of the method by the members. The Court cited extensively from its prior decisions in Associated Milk Producers, Lamesa, and Ford-Iroquois FS.

The Courts Do Not Agree With The IRS On The Pre-existing Obligation Issue

Inherent in the IRS view of netting is the belief that the pre-existing legal obligation requirement is not satisfied if the board of directors has discretion at year end to make business judgments concerning the allocation and payment of patronage dividends.

Although Subchapter T requires that a patronage dividend must be distributed under a valid legal obligation to do so, it has long been recognized that the board of directors may exercise certain discretion in allocating patronage once this requirement is met. In the Ford-Iroquois and Lamesa cases, cited above, the Tax Court found that the board of directors of a cooperative could, in its discretion, net losses from one function against gains from another and exercise its business judgment in allocating the earnings to the patrons of one year rather than the patrons of earlier years. The exercise of this type of business judgment by the board of directors clearly can be and has been exercised within the cooperative's general obligation to distribute its patronage earnings to members, and it should not affect a cooperative's ability to deduct its patronage dividends payments.

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The discretion exercised by the board in the Ford-Iroquois and Lamesa cases is typical of business judgments in the payment of patronage that must be made by a cooperative's board of directors as a matter of business practice. For example, the board may often determine whether to distribute patronage earnings or to hold all or a portion of these amounts in a reasonable reserve, whether to issue patronage in cash or in allocations, whether to issue qualified or non-qualified allocations, and when such allocations should be redeemed.

The members have chosen to give the board this discretion just as they have given the cooperative the discretion to buy and sell agricultural commodities for its various units and functions and to determine by such actions whether these parts of its operations will be profitable in the first instance. We believe that cooperatives do have the discretion to net losses from their allocation units and functions with gains from other allocation units and functions and that this action is perfectly consistent with their overall pre-existing legal obligation to distribute net earnings to patrons[2].

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2 The cases often referred to by the Internal Revenue Service to support their argument that no valid legal obligation exists where the board has discretion to net losses from one department against another, United Cooperative, Inc. v. Commissioner, 4 T.C. 93 (1944); Union Equity Cooperative Exchange v. Commissioner, 58 T.C. 397 (1972), aff'd, 481 F.2d 812 (10th Cir. 1973); United States v. Mississippi Chemical Co., 326 F.2d 569 (5th Cir. 1964), do not deal with losses or with netting or with the allocation of earnings to one group of patrons versus another. Those cases hold that where the board has no overall legal obligation to pay patronage, and particularly where the earnings may be used to pay dividends on common stock, the pre-existing obligation requirement may not be satisfied, but that is not this situation.

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Congress Should Reaffirm Cooperatives' Right To Net

Differences between the cooperative industry and the IRS over the netting issue have continued for a period of more than twenty years. During that time cooperatives have won a number of significant court decisions dealing with netting of losses, equitable allocation principles, and the right of directors to exercise sound business discretion in making allocation decisions. Nevertheless, the IRS has refused to acquiesce despite strong judicial language that the IRS' intrusion into the internal affairs of cooperatives is unwarranted. The technical advice memorandum issued in January of this year is evidence of the IRS' intent to press ahead on the netting issue in spite of what the courts have said.

The IRS' intransigence with regard to netting could not come at a worse time for agriculture. A no-netting rule would cause economic hardship for cooperatives and their members at a time when they can ill-afford additional financial setbacks. Furthermore, because cooperatives are under an obligation to return net margins to patrons, the patrons necessarily bear the costs of litigation.

Farmer cooperatives should not be required to continue to expend funds to litigate the IRS's views regarding netting. Even if cooperatives continue to win in court as expected, the IRS has shown no intention of modifying its position. Therefore, the National Council respectfully urges this Subcommittee to favorably report language along the lines of Senator Mattingly's amendment to reaffirm and clarify the right of cooperatives to net gains and losses within and among their allocation units.

Respectfully submitted,

James S. Krzyminski
Vice President &
General Counsel

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Senator CHAFEE. Mr. Fulton, do you have anything to add?

Mr. FULTON. Just to give a little breadth of opinion, I am from a relatively small cooperative. We only have 1,600 members. We are not a billion-dollar cooperative. Looking at competition from the other side, we compete with some fairly large companies.

Senator CHAFEE. What does your co-op do?

Mr. FULTON. We grow the Concord grape in the States of Washington, Arkansas, Missouri, Michigan, Ohio, Pennsylvania, and New York.

Senator CHAFEE. I thought you were in Massachusetts.

Mr. FULTON. That is where our headquarters is located. That is where the Concord grape was developed. The village of Concord, MA, gave its name to the grape. Grape growing, although it is still done on a very small scale in eastern Massachusetts, has become so unprofitable and land values have risen so much that it is just not an economically viable function in that area any more.

Senator CHAFEE. But is that where your headquarters are?

Mr. FULTON. That is where our headquarters is located.

Senator CHAFEE. And you grow them in Washington and Arkansas?

Mr. FULTON. Washington, Arkansas, Missouri, Michigan, Ohio, Pennsylvania, and New York.

Senator CHAFEE. You must do a lot of traveling.

Mr. FULTON. Yes, sir, I do. [Laughter.]

Senator CHAFEE. Go ahead.

Mr. FULTON. I do not have a prepared statement, but I would be delighted to respond to any inquiries you might have.

Senator CHAFEE. Let me ask you about the point that Mr. Mentz was making. On these co-ops, he was agreeable that they keep the ability to do what they have been doing, but as long as there wasn't this discretion in the board of directors. I think you were all here when he brought up that point. What do you say to that?

Mr. FULTON. As a practical matter, it won't work. It doesn't work. Business developments move too fast. There are too many unpredictable effects on all farmer businesses. It is not a U.S. market any more. It is not a regional market. Most of us really deal with the world market. We deal with problems which range from disease to world market effects. Events which develop can't always be identified in advance and anticipated. In fact, the rule is that can't be anticipated and provided for in advance. Farmers truly recognize this. This is a very difficult issue—this netting issue—or at least the IRS position on it—for farmers. In my experience, it is one that has been very, very tough for farmers to understand. They understand what mutuality and a cooperative effort are. And on their own farms, for the most part, they are diversified. They expect to lose money in operations and gain on others. They understand that the benefits from a cooperative aren't only on the balance sheet. The IRS for some reason wants to focus on dollars and cents. There are many other benefits from cooperative endeaver. Farmers understand that in a subsequent year they may be on the losing side on a certain crop and they are willing nonetheless to participate. And they really don't understand why the IRS is——

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Senator CHAFEE. He is not arguing that point. He is not arguing the point of netting. He is arguing the point that if everything is to be paid out on a patronage dividend, or if 50 percent is to be paid out on a patronage dividend, then that is OK. But if you let the board of directors have discretion—when things look pretty good we will pay out 70 percent; next year we will pay out 30 percent; and so forth and so on——

Mr. FULTON. My impression is, that is not the problem. I think we all understand, in the industry, that if we don't pay out a patronage dividend, we pay tax on it. I think he was more concerned about the discretion of how losses move between units. I know that is what he said, but I think the Service and the Treasury position is directed at the director discretion to move economic results between units within the co-op. You are right, Senator. He did say that. I don't think that is what the Service position is. I think its main concern is the movement of losses, not the decision to distribute patronage or not distribute patronage. When a cooperative does not distribute its earnings, it pays tax on them just like any other corporation.

Senator CHAFEE. So, he was really worrying about determining how to move around between the different profits or losses of the different crops?

Mr. FULTON. That is the Service's concern. That is not, in my experience, the farmer's concern. The farmer understands when he goes into the cooperative, whether he is a wheat or a cotton grower, how the cooperative operates. He is there for the long term, and he is there for the mutuality provided.

Senator CHAFEE. I gathered that when the farmer goes there, he is not innocent. He must know that if he is strictly a corn farmer, he may not pocket everything that comes from the sale of his corn.

Mr. FULTON. And at the same time, he may be receiving other less tangible benefits from his membership. For some reason the Service wants to focus on this one, balance sheet, dollars and cents element as the sole focus of the farmer's concern.

Mr. MULLIGAN. Senator, if I may respond to your point? I think we all understand that to have a deduction for patronage refunds, we must have a preexisting obligation. One of the questions gets to be: Does the board of directors have any discretion relating to trying to provide equitability as a result of some unusual events? Because of the cyclical nature of agriculture, whether that be a crop failure, an act of God, or whether that be an embargo or other actions that might change the profitability of individual departments, we believe that the board of directors needs some discretion to be able to come to grips with the unusual that do happen in our business during the year.

Senator CHAFEE. All right, fine. Thank you very much, gentlemen. I guess that completes it. Thank you for coming.

[Whereupon, at 10:46 a.m., the hearing was adjourned.]

[By direction of the chairman the following communications were made a part of the hearing record:]

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The Catholic Church
EXTENSION Society
OF THE UNITED STATES OF AMERICA
35 East Wacker Drive • Chicago, Illinois 60601 • (312) 236-7240

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July 29, 1985

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Betty Scott-Boom
Committee on Finance
Room DS-219
Dirksen Office Building
U. S. Senate
Washington, D.C. 20510

Re: July 9, 1985 Senate Finance Committee Hearing on the impact of tax reform proposals on charitable contributions

Gentlemen:

The Catholic Church Extension Society is a Not For Profit, Illinois Corporation. For 80 years, we have been the home mission organization which brings the Catholic Faith to the poorest adults and children in the remote and impoverished areas of America.

Our funds come solely from our benefactors, many of whom do not itemize on their federal income tax returns.

Under consideration is a tax reform proposal, which would repeal the charitable deduction for the 80 percent of American taxpayers, who do not itemize. This would greatly jeopardize The Catholic Church Extension Society's ability to continue our work in America because it would have a negative effect on many of our donors.

I urge you to make the charitable deduction available to itemizers and non-itemizers alike--making it an ALL-AMERICAN charitable deduction.

Thank you for your consideration in this matter.

Sincerely yours,

Very Reverend Edward J. Slattery
President

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Cooperative League
of the USA

Representing America's Cooperative Business Community

STATEMENT OF THE

COOPERATIVE LEAGUE OF THE USA

TO

SUBCOMMITTEE
ON TAXATION AND DEBT MANAGEMENT

OF THE

SENATE COMMITTEE ON FINANCE

Submitted by

E. MORGAN WILLIAMS
President
July 25, 1985

1828 L Street, N.W., Suite 1100 · Washington, D.C. 20036 · (202) 872-0550 · Cable: CLUSA

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STATEMENT

The Cooperative League of the USA is a national membership and trade association representing America's cooperative business community. The League serves as a chamber of commerce for cooperative businesses, representing the unique and mutual needs of the various industries. Membership includes all types of cooperatives including farm supply and agricultural marketing cooperatives.

Over the years, the Internal Revenue Service (IRS) has challenged cooperatives that have practiced netting of losses from one function against gains from another. In January of this year, the IRS issued a technical advice memorandum holding that cooperatives could not net losses from one department against gains of another department. Essentially, this would force each department of a cooperative to operate as a separate entity for tax purposes. The IRS has stated for at least 15 years that their position on the practice of cooperative netting is under review and study.

The Cooperative League supports Senator Mack Mattingly's amendment to make clear and reaffirm to the IRS that cooperatives are allowed to net losses against gains in its various allocation units in determining its taxable income. The Cooperative League also supports the views presented in detailed testimony by the National Council of Farmer Cooperatives.

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Cooperatives were first organized to market goods more efficiently, pool resources and spread the risk and benefits of production among its member-owners. From the beginning cooperatives have diversified not only in order to better serve the needs of their member-owners but to prevent bankruptcy if in a particular year a specific function or division suffers major losses. Every sound business organization recognizes the need to be able to survive a bad year financially. Having more than one division within a cooperative is a logical step to this end goal of being financially sound. If a cooperative is unable to net, the cooperative loses a significant reason for its existence: that of sharing risk among members.

Over the past years, the IRS has tried to restrict the ability of cooperatives to deal with losses and make allocations among its patrons, but the courts have upheld the ability of cooperatives to take these actions.

In Associated Milk Producers, Inc. v. Commissioner, 68 T.C. 729 (1977), the Tax Court allowed the cooperative to carry an operating loss forward from one year to another. In that case, the court found that the IRS's position was "...in short, an unwarranted tinkering with the tax structure applicable to cooperatives."

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In another case, Ford-Iroquois FS Inc. v. Commissioner, 24 T.C. 1213 (1980), the Tax Court found that a board of directors could carry losses frm one year forward to the following yer. The court stated that, "...the allocation of losses among a cooperative's past, continuing and future members is properly the concern of the membership and its board of directors." The court also found that the cooperative could net losses of its grain function against earnings from its supply function. In that case, IRS did not even challenge the cooperative's netting of losses within the supply function.

Cooperative members democratically elect their board representatives. Each member of the board of director has an obligation to act in a fiscally responsible manner in carrying out the business of the cooperative on behalf of the membership. The members also adopt and amend bylaws which determine the business rules of the cooperative. These rules may include giving the board discretionary authority to net and to determine the guidelines for such procedure. The Ford-Iroquois decision clearly shows that boards should and do have leeway in conducting a cooperative's business for the benefit of its members.

In Lamesa Cooperative Gin v. Commissioner, 78 T.C. 894 (1982), the IRS tried to prevent a cooperative from claiming a patronage dividend deduction on a gain from a sale of equipment depreciated before 1974 because the IRS found that the cooperative had improperly allocated this gain to its patrons -- it allocated the gain on the basis of patronage in the year of sale (1974), rather than the years over which the property was depreciated. However, the Tax Court found the board of directors had discretion to make

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a practical and equitable allocation of earnings among the cooperative's patrons.

As shown in these cases, the Tax Court has clearly stated that cooperatives have the authority to net within the framework of their overall pre-existing legal obligation to distribute net earnings to patrons.

The Cooperative League supports the enactment of language reaffirming that cooperatives may net losses of one or more allocation units against gains from other allocation units to determine patronage dividends for tax purposes.

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UNITED STATES SENATE

COMMITTEE ON FINANCE

Hearing Entitled

Tax Reform on Professional Organizations and Charitable Contributions

Written Statement of

Valleau Wilkie, Jr.

Chair of the Board
Council on Foundations, Inc.
Washington, D.C.

and

Executive Vice President
Sid W. Richardson Foundation
Fort Worth, Texas

July 9, 1985

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As Chair of the Board of Directors of the Council on Foundations, I would like to submit this statement to be printed as part of the official record for the hearing on tax reform noted above.

Representing over 980 foundations making annual contributions to charitable organizations in excess of $2.1 billion, the Council is vitally concerned about the potential effects of the President's tax reform package on the private sector. Dramatic cutbacks in Federal spending have occurred in the past four years and even deeper cuts seem inevitable in the wake of continued Federal deficits. Clearly, an increase in private charitable giving would help counteract this severe drop in Federal funding. Unfortunately, we believe that the President's proposal will discourage increased private giving, and will result in a significant drop in total charitable contributions.

Specifically, economic studies indicate that simply reducing the top marginal tax rate from the present 50 percent to 35 percent will result in a national decline in giving of over $4 billion annually. The Council on Foundations joins with the Independent Sector and others in accepting the effects of this rate reduction as the necessary by-product of establishing a fairer and more simplified tax system. But the President's proposals go farther, and it is with respect to these additional deterrents to charitable giving that we must voice our concerns.

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Non-Itemizer Deductions

Except in rare circumstances, members of the Council on Foundations are not directly affected by charitable contributions from non-itemizers. We do not voice our concerns, therefure, as a special interest. Most of our members do not depend upon annual contributions but rather have income from endowments from which they make their grants. Those members that do seek contributions annually -- especially our community founda-- tions -- are unlikely to receive them from non-itemizers. Nevertheless, everyone of our members is directly concerned with the economic stability of each of its grantees. Most charities receiving grants from foundations are vitally concerned about contributions from supporters who do not itemize. Foundations, therefore have a vital interest in the ability of non-itemizers to contribute to their grantees, and the Council on Foundations firmly supports retention of the non-itemizer deduction.

Gifts of Appreciated Property

In the vast majority of cases, foundations are formed by significant gifts of appreciated property. For several years now the Council on Foundations has reported to Congress our growing concern about the precipitous decline in the formation of new foundations. Since the Tax Reform Act of 1969, we have witnessed a 60 percent drop in the creation of new foundations. In an effort to help remedy this decline, Congress made a significant change in the law as part of the Deficit Reduction Act of 1984. Specifically, living donors may now make gifts of publicly traded stock to private foundations and obtain a full, fair market value deduction for the gift.

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Despite this encouraging improvement, we now face on the immediate horizon the President's tax proposal which would create a new tax preference item for purposes of calculating the alternative minimum tax. As proposed, taxpayers would be required to add back in to taxable income the long-term gain portion of any charitable gift of appreciated property. While we understand the concern for "fairness" which motivates this proposal, we are convinced that its effect will be to discourage significantly the gifts of appreciated property to all charities -- not just to foundations. It is estimated that nearly two-thirds of all gifts of appreciated property would be subject to a substantially higher price of giving compared with present law. In short, the progress we achieved in 1984 would be undermined, and our ability to encourage the formation of a new generation of private foundations and the continued growth of community foundations would be seriously weakened.

While we support the notion of fairness in the tax code, and we agree that taxpayers should not be able to avoid paying taxes entirely, we are convinced it can be done without creating this damaging disincentive to making gifts of appreciated property. First, it is important to remember that -- under current law -- no taxpayer may deduct more than 20 percent of adjusted gross income for gifts of appreciated property to a private foundation. This limitation alone provides a built-in mechanism to preserve fairness in the calcuation of a taxpayer's account. Second, the

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proposed crackdown on tax shelter schemes -- which have no similar built-in protection against abuse -- should deal effectively with the defects of the present tax system for which the minimum tax was devised and for which it continues to be used.

Community Foundations

Over 160 community foundations are members of the Council on Foundations and they are particularly concerned over this new restriction on gifts of appreciated property. Like universities and museums, they receive a substantial portion of their contributions in this form. Community foundations are not private foundations, and as a result must annually meet a public support test. Ironically, the more successful a community foundation is in gaining public support and building its endowments, the more it must raise each year to satisfy the support test. Endowment income cannot be counted in meeting this test. In short, the proposed change in the treatment of gifts of appreciated property would leave community foundations in a particularly vulnerable position. They would face the very real threat of losing their public charity status for failure to meet the support test if gifts of appreciated property are significantly discouraged.

For these reasons, the Council on Foundations opposes the suggested change in the treatment of gifts of appreciated property. True fairness in the tax code can be achieved without damaging this most important incentive to charitable giving and its significant effect on the ability of the private sector to respond to human needs.

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FARMLAND INDUSTRIES, INC.

post office box 7305/kansas city, missouri 64116

July 17, 1985

Senator John H. Chaffee
Chairman
Subcommittee on Taxation and Management
Senate Finance Committee
Washington, D.C. 20510

Dear Senator Chaffee:

This is to request that the attached statement by Farmland Industries be made a part of the hearing record on proposed legislation to clarify the right of agriculture cooperatives to net earnings and losses in different lines of businesses when computing taxable income.

On behalf of the Farmland System I want to express our appreciation for your willingness to conduct hearings on this matter even though we know that the schedule of business before the finance committee is very heavy. We believe this issue is of extreme importance to agricultural cooperatives and urge congress to act on this legislation at the earliest possible date.

We thank you for your consideration.

Sincerely,

Kenneth A. Nielsen

Kenneth A. Nielsen
President

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STATEMENT OF FARMLAND INDUSTRIES

FILED WITH THE SUBCOMMITTEE ON

TAXATION AND DEBT MANAGEMENT

OF THE SENATE FINANCE COMMITTEE

FOR INCLUSION IN THE RECORD OF THE PUBLIC HEARING

ON TAXATION OF NET INCOME OF COOPERATIVES

BY

KENNETH NIELSEN

PRESIDENT OF FARMLAND INDUSTRIES

Mr. Chairman, Farmland Industries urges the adoption of legislation to clarify the right of agriculture cooperatives to net earnings and losses of different lines of business for determining patronage refunds and computing taxable income. We have reached the conclusion that this matter cannot be resolved administratively and that a satisfactory and early resolution of the problem requires legislative action.

Mr. Chairman, Farmland Industries is a federated marketing and supply cooperative, owned by 2,200 cooperative associations operating in 19 midwestern states. These cooperative associations, in turn, are owned by approximately 500,000 farm families. The netting issue is of significance to each of the 2,200 local associations and to their 500,000 farm family owners.

The technical advisory opinion issued by the Internal Revenue Service on January 25, 1985, would have the effect of denying the cooperatives the long standing practice of netting gains and losses among their various operating divisions. If this ruling is allowed to stand, it would have the effect of requiring any cooperative which has more than one business activity or allocation unit, and most do, to operate each as a separate entity for tax purposes. In other words, if a cooperative makes money in one area (grain, for example), and loses money in another area (fertilizer, for example), all the earnings in grain would have to be allocated in the form of patronage dividends to the grain patrons and all the losses would have to be absorbed as if the cooperative were, in fact, two separate taxpayers. Forcing cooperatives to operate in this manner is completely contrary to the nature of cooperatives which is to join together in sharing risk for the mutual benefit of their members and would deny to cooperatives a practice which all proprietory businesses engage in. Furthermore, the approach that the IRS is recommending could lead to the absurd situation where a cooperative could have an overall net loss in a given year on its patronage business and yet still have a tax liability, because some of its departments or divisions were profitable.

XES520-15

Netting gains and losses among various lines of activity is dictated by common sense business practice. Moreover, it is clearly sanctioned, we believe, by subchapter T of the Internal Revenue Code which affords single tax treatment to qualified cooperatives.

In challenging the netting practice, the IRS in the past and in this current ruling raises questions about the discretion of duly elected board of directors to allocate gains and losses. We believe this is a specious argument. Farmer cooperative patrons are fully aware that their elected board of directors allocate gains and losses among the cooperative's various lines of activities and would not expect them to do otherwise as they decide how best to respond to contingencies that may occur during an accounting year. Furthermore, this in no way ignores or sets aside the prior commitment test to the obligation to allocate to patrons net earnings that may have occurred.

Mr. Chairman, it is highly significant that the federal courts have ruled against the IRS in three separate issues dealing with the netting issue. Those cases are:

Associated Milk Producers, Inc., v. Commissioner 68 T.C. 729 (1977)
Ford-Iroquois FS, Inc., v. Commissioner 74 T.C. 1213 (1980)
Lamesa Cooperative Gin v. Commissioner 78 T.C. 894 (1982)

Mr. Chairman, the no-netting proposal of the IRS would affect any cooperative regardless of size that engages in more than one line of activity and as a result a great number of farmer cooperatives in this country could be adversely affected. This could only serve to compound the already difficult economic conditions in agriculture today.

The position of the IRS, we believe, is legally unjustified and is economically untenable. Given the fact that the IRS has persisted in pursuing this issue in the face of critical court decisions, Farmland Industries concludes that legislative relief is necessary to provide a sense of certainty and to relieve cooperatives of the risk of unnecessary and expensive litigation. We do not have confidence that this matter can be resolved administratively, as the spokesman for the Treasury Department argued when he appeared before your committee on July 15. Therefore, we request that you give serious and careful consideration to prompt action on this legislation.

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STATEMENT OF DEAN KLECKNER
ON BEHALF OF THE IOWA FARM BUREAU FEDERATION
BEFORE THE SENATE FINANCE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

RE: Tax Treatment of Cooperatives -- "Netting"

HEARING DATE: July 15, 1985

Mr. Chairman and Senators, my name is Dean Kleckner. I am president of the Iowa Farm Bureau Federation and have served in this capacity since 1975. I farm near the small Iowa community of Rudd, raising hogs and corn.

The Iowa Farm Bureau Federation is the state's largest general farm organization with a membership of approximately 150,000 families, many of whom, as am I, are members of their local cooperative. It is on their behalf that this statement is presented.

It has become a tragic cliche that farmers are experiencing the most severe period of financial stress since the great depression. This factor has demonstrated the interdependence of the agricultural economy and main street businesses, including the farmer-owned cooperative.

In recent weeks, three farmer-owned cooperatives have been dissolved by a vote of their shareholders in southern and southwestern Iowa. These areas of the state have been hit particularly hard by the agricultural crisis. It became apparent to the cooperative members that the institutions were no longer able to continue operating viably, thus the dissolution vote.

Cooperatives, however, have a long history of providing needed services and products to American farmers. A January, 1985, IRS ruling that a farmer cooperative does not have the right to net gains and losses among its various functions or departments jeopardizes the ability of a cooperative to provide a variety of services for its members. It further unfairly penalizes farmer cooperatives and ignores a basic tenet of cooperatives -- that of risk sharing.

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Cooperatives are a risk management tool organized by and for farmers. The decision to diversify, to provide new services to members, should be based upon member needs and the current tax treatment of a cooperative as a single taxing entity, notwithstanding the objections of the IRS.

A frustrating outgrowth of the position taken by the IRS in these matters is the litigation expense incurred by cooperatives and their farmer members. The Tax Court has consistently ruled against the IRS, upholding a cooperative's patronage distribution scheme. The IRS seemingly wishes to make the business decisions for the cooperatives, ignoring the cooperative's right of self-determination.

The IRS further ignores the fact that cooperatives are voluntarily established. They are maintained in a self-regulating manner, that is, if members are dissatisfied with cooperative management or programs, they are free to do business elsewhere.

One additional point needs to be brought to the attention of this committee. Cooperatives have historically offset losses in one division from the profits in another. Thus, a legislative or administrative remedy of the netting issue would result in no revenue loss to the treasury. While it is our hope that the IRS will administratively recognize the cooperative's right to offset losses, in absence of this action we urge a prompt legislative resolution of this matter.

Respectfully submitted,

Dean Kleckner

Dean Kleckner, President
Iowa Farm Bureau Federation
5400 University Avenue
West Des Moines, IA 50265

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Statement of

Land O'Lakes, Inc.

to be filed with

The Subcommittee on

Taxation and Debt Management

of the Senate Committee

on Finance

July 26, 1985

By

Ralph Hofstad

President

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July 26, 1985

On behalf of Land O'Lakes, I am submitting this statement in support of the proposed amendments relating to the netting of losses and profits of cooperatives. We believe the ability for cooperatives to net losses to profits within a given year is essential for the successful operations of farmer cooperatives.

Land O'Lakes, Inc. is a regional farmers cooperative serving farmer members in a eight state area in the upper midwest. The control is in ten thousand individual farmer members with one vote per member and in approximately twelve hundred local cooperative associations which are in turn controlled by one member-one vote of approximately three hundred forty thousand farmer members.

Land O'Lakes was organized by a few dairy producers in 1921 in order to market processed dairy products in the more populated regions of the United States, most notably in the East. Those dairy producers needed many agricultural supplies in order to conduct their farming operations and thus expanded the functions of their cooperative in succeeding years to provide feed, fertilizer, seed, milking equipment, petroleum products and other farm supplies.

With the advent of hundreds of local creameries becoming no longer economically viable because of modern technology being introduced into dairy processing requiring heavy capital

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expenditures, efficient transportion facilities, modern management techniques, and the need for expanded markets most of those local creameries became members of Land O'Lakes, Inc. or one of the other major dairy processing organizations.

Dairy and other commodity farmer members of Land O'Lakes, Inc. and other cooperatives, through their democratically elected Board of Directors, proposed mergers with other farmer cooperatives located in the upper midwest. Those mergers over the years were approved overwhelmingly by the members of each of the affected cooperatives on a one member-one vote basis. The objective was to combine with other farmer cooperatives with similar purposes, i.e. to enhance the combined purchasing power and marketing power of farmers in order to compete in modern day agri-business both domestically and worldwide.

The result in 1985 is a multi-functional cooperative composed of many economic centers providing for the marketing of commodities, further processed dairy and other foods, agricultural inputs of all kinds and a multitude of services needed for efficient farming today.

The control is the same as it was in 1921: in farmer members on the basis of one vote per member. They adopt the instruments of control. They and they only can amend them. They elect the Board of Directors through a system where they and they only nominate them. They attend district, regional and annual information meetings and make their wishes known. They receive numerous reports and they understand the cooperative way of doing business. If there are earnings they share in them and they share in the risks. They understand

that new ventures require capital investment and most often a subsidy for a period of time. They most certainly know that the vagaries of weather, both regionally and globally, affect their production and their prices. They are intimately aware of short term farm programs that make long term planning impossible. They know that the personal economic interests of dairy, beef and hog farmers and corn and bean producers may not be the same. High corn and bean prices translate into higher production costs for animals and vice versa. But they believe in cooperation for their mutual benefit and the viability of their cooperative association.

They are willing to share those risks through their cooperative on a basis that they have approved, i.e. the sharing of risks and of rewards. They understand that their by-laws cannot deal with every possibility or combination of profits and losses but that it gives the Board of Directors reasonably clear guidelines as to how losses and profits are to be distributed. They receive notice of their overall patronage dividend and how it was computed and if they want to change the method of distribution they can by amending their by-laws.

They also understand that the single tax treatment applies and are willing to and do bear their fair share of taxes when there are earnings distributed to them whether in a cash or non-cash form.

I submit that Land O'Lakes, Inc. along with other farmer cooperatives are among the most democratically controlled institutions in the world and that if we believe in democracy we ought to let the farmer members decide how they want to

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share the risk and rewards of combining their economic entities and that tax revenue is not lost as the single tax treatment applies and is working.

On behalf of the three hundred fifty thousand farmer members of Land O'Lakes, located in the eight states of the midwest, we support the proposed amendments to the Internal Revenue Code which clear up any ambiguities that might exist relating to the subject of the netting of profits and losses betwen functions of a cooperative.

Respectfully submitted,

Ralph Hofstad
President

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July 15

Written Statement Of

National Grape Co-operative Association, Inc.

For Submission And Inclusion

In The Printed Record

Of The Hearing Of

The Subcommittee On

Taxation And Debt Management Of The

Senate Committee On Finance

July 15, 1985

Regarding The Legislative Proposal Of

Senator Mack Mattingly

To Reaffirm The Propriety Of The

Netting Of Income and Losses Of

Different Units Within Single Cooperatives

The essential effect of the Service's netting prohibitions is to create separate taxable, financial, and otherwise fragmented entities within each cooperative. Should the Service be successful in imposing this wholly unwarranted and unprecedented result, it would at a minimum severely limit, and at e maximum terminate, the capacity of agricultural cooperatives to achieve the benefits of legitimate diversification. Business economists and financiers would view such a development with alarm. Not only would agricultural cooperatives be thereby prevented from efficiently and effectively serving their farmer members (conduct which is legislatively mandated at both the state and federal levels), many would be destined for precarious financial status and many more condemned to financial disaster. The long-term impact on farmers and the communities in which they live of this no netting or fragmentation principle would be devastating.

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From a farmer cooperative perspective, no issue is more perplexing from a sound business practice viewpoint, more threatening to the smooth collection of the revenue and more damaging to respect for our system of income taxation than the Service's espoused position regarding the allocation or netting of losses. It is contrary to the long prevailing attitude and philosophy of the Department of Agriculture, the consistent theme and harmony manifested in judicial decisions, including those of the Tax Court, and the need to foster predictability and efficiency in the administration of the internal revenue laws and to reduce the volume of litigation in our courts. The need for interpretive activity by the Service to fill gaps in the revenue acts is not questioned by this or other cooperatives. What we do question, and must object to, is a persistent effort to shape rules which are beyond the succinct and unambiguous boundaries established by our courts and which cannot be imputed to our legislators.

No question of uncovering a new and previously untapped source of revenue is involved. Whether the Service goes forward or is reined in is without effect on the revenue. At issue rather is the matter of whether the Service, contrary to the normal processes of government and established judicial and legislative authority, may anoint itself as a kind of super-regulatory agency for cooperatives to judge which internal business structures and what business decisions, otherwise perfectly proper and acceptable for every other type of business enterprise in this country, are fit or not fit for farmer cooperatives. After consulting an oracle whose prejudices and fallability are beyond the

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ken of our farmer members, the Service would first chisel in granite the range of business and operational decisions which are available to farmers and their cooperative boards of directors and then sit in judgment on the matter of whether, under whatever circumstances may be deemed relevant after the fact, the business and operational decisions actually undertaken were correctly made.

The unknowing, inflexible hand of the Internal Revenue Service must not be permitted to reach inside farmer cooperatives to impede and stultify the genius and enterprise which is lauded and encouraged in every other form of business organization. At stake is economic viability and the capacity of farmer cooperatives to survive and change in changing economic contexts. The confusion, uncertainty and litigation which is being spawned must be stopped. To do so is not to establish any new rule. To do so is to restore in practice the structure and integrity of Subchapter T of the Code. For these reasons the Mattingly proposal should be enacted into law.

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STATEMENT ON THE NETTING OF INCOME
AND
LOSSES OF FARMER COOPERATIVES

This written statement is submitted for inclusion in the printed record of the hearing held July 15, 1985, by the Committee on Finance of the Senate of the United States on a proposal by Senator Mack Mattingly (R-Georgia) to allow the netting of income and losses of different administrative units within a single farm cooperative.

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This statement is submitted on behalf of the Nebraska Counsel of Farmer Cooperatives. A recent Technical Advice Memorandum (January 25, 1985) has again raised the question of the extent to which the National Office of the Internal Revenue Service is to be allowed to interfere in the business operations of a farmer-cooperative. At the outset, it must be recognized that any such interference is just that, simple interference in business management of a cooperative, because it has no tax consequences. A farmer cooperative operates in such a fashion that it refunds to its patrons substantially all amounts it receives in excess of cost of operation, whether it is a marketing cooperative (that is, it sells the crops raised by its patrons for them) or a supply cooperative (it buys for them the supplies, such as petroleum and fertilizer, that its patrons need in their farming operation). It also should be recognized that there is nothing unique or extraordinary about these refunds being excludable from the income of the business entity for income tax purposes. For example, if General Motors entered into an agreement with each of its customers for the year 1986 that it would refund to them such customers' proportionate share of the amounts received, throughout the year, in excess of the cost of operation those refunds would reduce General Motors' tax to zero.

Somehow, the Internal Revenue Service finds this business procedure repugnant and has, for years, attempted to interfere in the business operations of the cooperative. Your attention is

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respectfully drawn to a case decided by the Circuit Court of Appeal for the Eighth Circuit in 1961, Pomeroy Cooperative Grain Co. v. Commissioner, 288 F.2d 326 (which is quoted in the Technical Advice Memorandum which has occasioned this hearing). The Service has, since 1961, continued to ignore the admonition by the Eighth Circuit contained in a footnote at page 332, the second paragraph of which reads as follows:

> "There is some doubt whether the Commissioner has sufficient standing to object to the taxpayer's method of allocating what would normally be income excludable to the taxpayer among its member-patrons in a manner apparently acceptable to such members as an equitable distribution of profits."

And further ignores the holding of the case immediately preceding the "Pomeroy" case, Farmers Cooperative Company v. Commissioner, 288 F.2d 315 (1961) where the same Court stated, at page 326, as follows:

> "When the Commissioner seeks to set up new and different standards and requirements at a variance with what was considered acceptable practice before, fairness requires that the Commissioner make information available to affected taxpayers by regulation or in some other reasonable way."

Despite these clear sign posts by the Court, the Service has repeatedly tried to interfere in the business management of farmer cooperatives. This hearing merely represents a response to the most recent such attempt at interference.

I know that you will receive from your Staff detailed legal memoranda showing the attempts, starting with the Rochester Dairy case, by the Service to direct the tax procedures to be followed by a

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cooperative in the event it suffers a loss in a particular operation. Cooperative are owned and controlled by the member-patrons. The Service obviously believes that it, not the owners, should dictate the business practices of the cooperative. Almost uniformly the Courts have rejected this claim, no matter how urged.

Apparently, only Congressional action will terminate these unwarranted activities. With all the problems besetting agriculture in this country today, the IRS should not be allowed to impose on the farmer owned enterprises the additional expense burden of proving through the Courts a position that the Courts have repeatedly affirmed, that it is of little or no concern of the IRS how the cooperatives handle losses, as long as they do it within the framework of the existing Code.

Respectfully submitted,

NEBRASKA COOPERATIVE COUNCIL

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